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ABSTRACT

This document presents seven papers that address several aspects of the new direct lending federal loan program established by the Student Loan Reform Act of 1993. Among the topics examined are the following: (1) the experiences with implementing new student aid programs; (2) the policy questions involved in lending in proprietary (profit-making) trade and technical schools; (3) a review of the problems and prospects of the components of the old system of guarantee agencies; (4) questions concerning the use of the Internal Revenue Service as a vehicle for student loan repayment; (5) the development of a management system to permit evaluation of policy outcomes; (6) the issue of consumer education about the new program and other information; and (7) the technical issues of evaluation that surround the enactment of direct lending. Papers and their authors are as follows: "Policy Implications of Direct Lending - Possible Unintended Consequences" (Martin Kramer); "Proprietary Schools and Direct Loans" (Richard W. Moore); "Summary of Student Loan Reform Act of 1993 - Projected Effects on Guarantee Agencies" (Peter Keitel); "Issues in How Federal Student Loans Will be Repaid in the Future" (Arthur M. Hauptman); "Driven Management Information System - Identifying Information Requirements for Evaluating Policy Outcomes" (Ray Haines); "Direct Lending and Consumer Information" (Sandy Baum); and "The Federal Direct Student Loan Program - New Era or Old Error?" (Elizabeth Bauer Hicks). (Contains 10 references.) (GLR)

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SELECTED ISSUES IN THE FEDERAL DIRECT LOAN PROGRAM

A Collection of Commissioned Papers

1994

U.S. Department of Education
Office of the Under Secretary
and
Office of Postsecondary Education

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FOREWORD

It is with pleasure that we present to the higher education community the following papers on several aspects of direct lending, a new Federal loan program established by the Student Loan Reform Act of 1993. Our purpose in making these papers available is to assist those who have new responsibilities in direct lending become aware of other perspectives on these issues.

The papers were written by members of the Direct Loan Steering Committee, a group convened by the Department of Education in early 1993, to provide expert advice on issues surrounding operation of the new program. The committee met on four occasions in 1993, and will continue to meet on an as-needed basis for the indefinite future. Its 10 members are:

Sandy Baum, Department of Economics
Skidmore College

Robert F. Boruch, School of Education
University of Pennsylvania

David W. Breneman, Graduate School of Education
Harvard University

Ray Haines, President, Reach for Excellence, Inc.

Arthur Hauptman, Consultant

Elizabeth Hicks, Financial Aid Officer
Harvard University

Kenneth Howard, Financial Aid Officer
University of District of Columbia

Peter Keitel, New York Higher Education Services Corporation

Martin A. Kramer, Consultant

Richard W. Moore, School of Business Administration
and Economics
California State University - Northridge

It should be noted that the opinions expressed in each paper are those of the individual authors only and do not represent the views of the Department of Education or of the steering committee as a whole. The name "steering

committee" is intended to distinguish this group from a Federal Advisory Committee, for we do not put forth our views as representing a consensus within the committee, let alone within the broader education community. The steering committee functions as a group of 10 individuals with no common agenda other than to provide whatever useful advice we can offer to those responsible for administering this new program. It is in this spirit that the following papers were commissioned.

Martin Kramer's paper draws on his extensive experience with implementation of new student aid programs in the late 1960s and early 1970s. As is true of any program, unintended consequences followed from those early efforts, and Martin Kramer reflects on that experience to help administrators anticipate and minimize such consequences of direct lending.

Richard Moore concentrates on issues of lending in proprietary (profit-making) trade and technical schools. Many of the problems with the existing Federal Family Education Loan (FFEL) program occur in the proprietary sector, and Richard Moore's paper raises the types of policy questions that must be addressed for this sector under direct lending.

The multi-year shift from FFEL to direct lending poses perplexing transition problems, for the phase-in assumes a continuation of the older programs for a number of years while the new program comes on stream. The financial survival and capabilities of guarantee agencies and other institutional parts of the older programs are at issue, and Peter Keitel's paper provides a balanced view of the problems and prospects of the components of the old system.

One of the promises of direct lending (although technically a separable issue) is the possibility of income-contingent forms of loan repayment, including the possible use of the Internal Revenue Service as a vehicle for repayment. Arthur Hauptman examines some of the tricky questions that must be addressed if this new form of repayment is to work.

Evaluation of direct lending is a crucial issue, for the many claims and counter-claims about its costs and benefits were a central part of the debate over its enactment, and it is essential that actual costs and benefits

be defined and measured as the program develops. Ray Haines' paper discusses how a management system can be developed to permit evaluation of policy outcomes.

A central issue in the success or failure of this new program will be the degree to which young people and their parents understand how it works, including when debt makes sense, in what amounts, and in what form. Sandy Baum examines this critically important issue of consumer information, and advances several recommendations to enhance the prospects for success.

Technical issues of evaluation will be central to accurate policy judgements about direct lending, and Robert Boruch's paper suggests ways in which useful work can be done in this arena. The controversy surrounding the enactment of the program makes it all the more important that reliable evaluations of its strengths and weaknesses, its costs and benefits, can be made.

The final paper by Betsy Hicks looks at many of the "nuts and bolts" issues that must be addressed at the institutional level as well as the systems level if the new program is to succeed. Her paper will be particularly valuable to campus financial aid offices as they enter the program.

We hope that these papers will provide insight and assistance to the thousands of people at the Federal, state, and institutional levels who have responsibility for implementing direct lending. All signs indicate that borrowing for college will continue to grow in financial importance, and thus the entire nation has an immense stake in the success of this new venture.

David W. Breneman, Chairman
Direct Loan Steering Committee

Policy Implications of Direct Lending

Possible Unintended Consequences

Martin Kramer

Overview

The paper provides examples of the kinds of unintended consequences of direct student lending that could be troublesome if they in fact occur. The paper categorizes such problems as (I) those resulting from the broader economic and financial context of direct lending, (II) those resulting from specific changes in behaviors, and (III) those resulting from efforts to deal with problems of the other two kinds. Preventive and monitoring strategies are suggested.

The Problem of Unintended Consequences

Program changes such as those that will create direct student lending inevitably change the choices open to program participants and the relative advantageousness of some behaviors relative to others. We very understandably focus on those consequences that are benign -- in this case, the benefits that will accrue to Federal taxpayers and students themselves. After all, to achieve these benefits is the purpose of the program changes. We should, however, also look for changed options and incentives that may not be benign. For much of their history the Federal student loan programs have been dominated by concern for unintended results of policy. We should try to anticipate now what unintended results could possibly flow from the shift to direct lending.

Some such problems can be dealt with in advance and generically, as it were. For example, distorted incentives could easily result from any situation in which the present value of a student's obligation under each repayment option open to him at any point in time were not exactly equal to that under each other option. To avoid these distortions, this equality can be scrupulously insisted upon. This is not necessarily a simple matter when future deferment options, loan consolidation options and inflation are all taken into account. However, at least we can know what we are aiming at.

Other problems of unintended consequences are not so easy to deal with, even in principle. These other problems are ones that result from how the various program participants see their situations, possibly with distorted and surely with fallible vision. Such problems cannot be entirely predicted and rationally prevented. The best the department can do in these cases is to anticipate what we can, monitor what is happening and try to head off trouble at the first indication. There should be some comfort in the fact that most of the past distortions and abuses in the student loan programs have taken several years to become major problems. There usually has been time to take corrective action, the Congress willing.

A convenient way to categorize possible unintended results of the direct loan program is to divide them into:

I. Problems that may arise because of the broader economic and financial context of direct lending.

II. Problems that may arise as all the parties to direct lending (students, parents, institutions, Federal administrators and contractors) play out their roles in the new program.

III. Problems that may arise when the Federal government is tempted to react inappropriately to problems of the other two kinds.

I.

The broad economic and financial context of direct lending has a number of features that are troubling. Many people have charted the increasing reliance on loans relative to grants over the past fifteen years. The reason has been the entitlement, off-budget character of educational loans in an era of rising costs and increasing competition for budget resources at Federal, state and institutional levels. Because students themselves have incurred most loan liabilities, the trend toward reliance on credit has resulted in a shift of real burdens -- in the case of younger students at least -- from parents to offspring. The burdens have become greater as inflation has subsided and as loans in the Federal programs have come to be less heavily subsidized in both real and nominal terms.

For many students there have been only two ways to avoid or minimize borrowing in the context of rising educational costs. One has been to attend a less expensive college. The other has been to pay for college as much as possible out of current earnings, even when this has meant less time for study and/or a longer time to degree completion. There is no good information on how many students have made these choices mainly or only partly to avoid greater dependence on loans, but the numbers are probably very large. There is also some evidence and much plausibility to the view that loan aversion is greater among some groups of "non-traditional" students and members of ethnic groups who may doubt their chances of achieving earnings adequate to carry loan burdens.

It is hard not to see parallels between our patterns for financing higher education and for financing health care. In both cases the method of financing available to meet rising costs (health insurance, student loans) has constrained use of the services in question on the part of those who public policy would like to see have greater access to the services. Low-wage jobs provide both

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less health insurance coverage and less ability to repay educational loans. In both cases the financing mechanism has provided too little restraint on costs, making the difference in ability to pay between members of different social classes even harder to bridge.

The most important question about unintended consequences of direct lending is whether the new program will make these problems worse. Possibly, because more students will have assured access to credit, this could mean less resistance to rising costs. No simple answer is possible, however, for a number of reasons. If there are many students who are now reluctant to borrow, there are likely to be even more as tuition costs and lending maxima rise in tandem. They will resist rising costs. It is also possible that more adequate and more certain credit resources to meet college costs will ease a transition to "high tuition, high aid" policies on the part of states. Such a development could help greatly in improving access to college for low income students. Further, such a development could make the connection between higher institutional costs and higher tuition charges at public institutions much more visible to middle and upper middle income families who have not had to struggle much to meet these charges in the past. More willingness to challenge high costs might result. Thus direct lending might even prove positively helpful, although indirectly, in achieving a more cost-conscious post-secondary system.

In any case, these are by far the most important areas to watch for second-order consequences of direct lending: its effects on access, real costs and the sharing of financial burdens among generations. Just as in health care, the way we pay can interact with how much we pay and who pays what shares. Making it easier to pay for college (as direct loans would do) can help access, but, even as it helps, it can permit costs to rise, adversely to affordable access, and/or it can shift the burdens of payment. The Department will want to monitor these effects closely in order to be informed about what is actually happening. Tuition levels, borrowing levels for students of differing family incomes and student vs. parent borrowing will be important indicators to watch.

II.

The Department should also monitor how each of the different parties to higher education finance behave in the new context of direct lending. There follows a sampling of situations that could be troublesome in one way or another:

The Rate of Program Growth

The most important factors here are, of course, increases enacted by Congress in loan limits. However, direct lending could well have the effect of causing new, higher levels of aggregate lending to be reached much more quickly than would otherwise be the case. The complexity and multiple levels of application processing characteristic of the old system have represented a kind of drag or friction, undesirable in itself, but serving to slow trends in aggregate lending. Consider, for example, how slowly lending to community college students began to catch up with their eligibility. The complexity of the loan origination process and a wish to avoid this "hassle" were surely factors (among others) in the slowness of this growth. This kind of "brake" will now be removed. And, as others have pointed out, its removal may occur at the same time that barriers tending to exclude relatively default-prone potential borrowers are being relaxed.

The Aid Packaging Process

A good many students (perhaps most) give little attention to the composition of the aid packages they receive. For example, studies have shown that students have no clear idea what part of the aid they receive is from Federal sources as opposed to state government or the college itself. In the past, however, students tended to be relatively clear about what part of their aid packages represented bank loans, because they had to deal separately with the banks and sign the bank's loan documents. With direct lending, this will no longer be the case. Students will tend to focus even more than they now do on the bottom line: whether total aid of all types from all sources will make college attendance financially feasible.

At the same time, the colleges and other post-secondary schools will know with much greater certainty than now how far they can rely on student loans to meet their goals with respect to net tuition revenues and aid funding. As a result, the mechanisms that are partly responsible for the rapid tuition increases in the last decade will function even more smoothly. This loss of "friction" calls for close monitoring of trends in tuition changes and better pre-loan counseling.

The Sharing of Burdens between Parents and Offspring

It has been known for a long time that many parents agree privately with their children that they (the parents) will pay off their children's student loans. Program changes from time to time have determined the degree to which such agreements are financially advantageous strictly speaking, or rather represent a sense of parental obligation. In any case, I have never seen estimates that

such agreements cover less than ten percent of student loans, and I have often seen estimates of fifteen percent or more.

The repayment options proposed to accompany the direct lending program could have a significant impact on these parent-offspring undertakings. By making student loans easier for the student himself to repay and by postponing the decision about how they will be repaid, it is quite possible that fewer loans will be covered by such agreements. Income contingency repayment plans especially could greatly increase the share of financial burdens placed on the student generation.

Such a shift could have further consequences. There may be more cases where student borrowers perceive their student loans as more unfair than in the past, even if easier to repay, because they will actually be paying them off themselves. They will be paying higher real interest rates than in the 1970's and 1980's, there will be higher loan limits more fully utilized and neither defaults nor parental generosity will provide quite the escape provided in the past. We could see borrower resentment at the financing system reach hitherto unheard-of levels, and corresponding pressures for the Federal government to do something about the perceived burdens.

Tracking Borrowers

The Department's plan to set up a single account for all loans to a particular borrower promises to solve a great many problems, but it will not solve one problem -- that of promptly updating information on the borrower's current status and location. If a borrower misses one or two payments, however inadvertently or however good his excuse, and if his location and status are unknown to the servicing contractor, a situation is created in which a borrower can get out of the habit of making payments, which is, after all, an unpleasant activity. The conventional wisdom of bankers is that making prompt payments needs to become and remain habitual and that serious delinquency or default is much more likely to result if there is no such habit or if it is broken. To the extent that student loan defaults result from such a break in contact, the problems are potentially as worrisome for direct lending as for the existing programs -- or, indeed, for any other sort of student loan program.

There are aspects of direct lending that may help somewhat. Being obligated to make payments to the government might make borrowers take their periodic payment obligations more seriously. Especially this could be the case if the IRS is involved in collections. Efficient consolidation of all the individual borrower's loans should also help somewhat, taking away any excuse that the repayment system is too complicated to cope with.

Will these positive effects be powerful enough to reduce the tracking problems? Somehow, I doubt it. What has been needed in the existing program and what may well be needed equally in direct lending is a clear, positive incentive for keeping up with repayment obligations. Such an incentive might be an automatic increase in the interest rate charged the borrower for the balance of the repayment period if he misses one or two payments. Other incentives might also be devised.

Collateral Opportunism

This term is used here for mischief that occurs, not in the making and servicing of loan themselves, but in combination with other practices of educational institutions. The term is intended to include some kinds of fraud and abuse, but also other practices that are not necessarily reprehensible morally or legally, but are still undesirable as a matter of public policy. The chief concern here has to be that already mentioned -- the loss of the modest brake on rising college costs the old too-complicated system provided.

An assured source of credit to finance tuition increases and to enhance net tuition revenues, however, provides only one of the incentives that need to be guarded against. There will be other practices that will also be tempting, the more so as they are likely to seem altogether benign. An assured source of loan capital will, for example, make it much more feasible for an institution to adopt, or to continue, a need-blind admissions policy -- a policy that has strong equity considerations in its favor. An increase in the institution's student self-help expectation can make such a policy more viable, and an increase will be less risky with direct lending. Also apparently benign would be student-budget financing of such things as higher student living standards, travel abroad and the purchase of computers. Such practices will be seen as both improving educational quality and making the institution more attractive in competitive recruiting. But they will also increase the aggregate costs of higher education.

The Special Case of Non-Originating Institutions

Where the educational institution itself originates loans for the Federal government, there will be plenty of occasions for oversight of their practices. This oversight can guard against collateral opportunism, including fraud and abuse. At a minimum, such oversight can provide early warning of problems. The risk of undesirable practices is probably much greater where the educational institution is not permitted to originate loans and this is done instead by a contractor. There will be a greater risk because of the sheer distance in these cases between loan origination and institutional practice -- both geographic and administrative distance. It would be worthwhile for the Department to review a comprehensive list of the ingenious scams that

multiplied when there last was such distance, that is, under the old FISL program.* The Department should ask whether similar scams could operate under direct lending.

Some of the old scams will, of course, be prevented by the mechanisms of a direct lending program. For example, there were a good many instances of collusion between lender and school in the FISL program to create schemes that provided the lender with an actual rate of return on its capital greater than permitted by statute. This will not be a problem with direct loans, because the capital will be that of the Federal Government.

There could, however, be other abuses. For example, there could be bait-and-switch scams that would lure students into enrolling and borrowing by rebates of one kind or another. A deliberate policy of special vigilance toward non-originating institutions would seem wise. Special audits and special audit guidance would seem to be in order.

Loss of Guarantee Agency Intelligence

The role of the guarantee agencies in the existing programs has been costly and administratively troublesome. Elimination of this role may therefore be regarded as desirable. It should be remembered, however, that these agencies have represented a valuable source of information about trends in the student loan programs. Officials in these agencies have often served as reverse ombudsmen, protecting the Federal interest as well as their own. They have compared notes and gossip from which those in Washington have often learned important things, for example, about proprietary school practices. The Department should think about how this source of intelligence could be replaced. If the Department is not fairly certain that such an information network will arise spontaneously under direct lending, it should perhaps set about deliberately creating one.

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*In FISL, institutions did originate loans, but oversight was extremely remote.

Choices that Borrowers Regret

The Department has wisely decided against offering any repayment option in which cross-subsidization would occur. This decision will prevent many situations in which borrowers might find they had made a disadvantageous choice of repayment plan. Scrupulous observance of an equal-present-value standard (mentioned earlier) will also help avoid situations in which borrowers are likely to regret their choices, at least on rational grounds.

Nonetheless, there could be problems. For example, any plan that accelerates repayment of principal will affect adversely the debt service capacity of borrowers as measured by commercial lenders from whom the borrowers might seek credit. It seems wise to allow borrowers to avoid this kind of problem by switching repayment plans once or twice, in effect refinancing their student credit.

More worrisome, but also speculative, is the possibility that some class of borrowers will feel (however irrationally) adversely impacted by the choice of a repayment option more common among members of the class than among members of some other class. Suppose, for example, that it becomes part of the recruitment strategy of certain proprietary schools to urge the benefits of the income contingency plan. Will there be resentment if this choice has the result of committing their borrowers to much longer repayment periods than those of co-workers? It could happen. Could there be similar resentments among borrowers of different genders or different races, social classes or regional origins? An equal-present-value standard would make such resentment irrational, but we have to be concerned nonetheless. Perhaps the most that can be done in advance is to make it crystal clear in borrower counseling that there are no cross-subsidies in any plan at any point.

Public Relations Hazards

I do not know what planning the Department has done to present data on the direct loan programs to the Congress and the public. It will be worth doing some planning, because some numbers produced by the program have a good deal of potential for adverse criticism. Five examples will make this potential clear:

- One way and another Sallie Mae will always try (understandably) to screen loans, so that those for which it takes responsibility will be as trouble free as possible. The Department will not have this option and, as a result, its loan portfolio will always appear to perform less well. Sallie Mae should not be the standard. The Department should take the trouble to devise a more meaningful and neutral standard for such comparisons.

- When unemployment is high, borrowers are likely to flock to an income-contingent repayment option and they will probably drift away when unemployment is low. Amounts of principal and interest paid will accordingly fluctuate -- in the eyes of some, alarmingly. The Congress and the public should be prepared to see such fluctuations for what they are, the natural result of giving student borrowers a set of convenient options.

- There will be some circumstances and periods in which default rates and program costs are low for reasons that have little to do with the real success of direct lending. It will be tempting to make too much of the rosy picture that results -- too much, because when conditions change the performance of the program will tend to look that much worse. Good performance criteria are essential for public relation purposes as well as for serious evaluation.

- It is quite possible that direct lending may make income-contingent repayment look bad. The opposite is also possible: income contingent repayment may make direct lending look bad. In other words, these two distinct program initiatives have been yoked together. It will be important to find ways to evaluate them separately that will be intelligible to the public.

- For reasons others have pointed out, there may be a "flight" of certain categories of borrowers from the existing programs to direct lending. Such "flight" can complicate invidious comparisons of the two.

III.

If problems arise under any of the foregoing headings it may be tempting for the Federal government to try to "fix" the problem in ways that are unhelpful in the long run. The Department could find itself under considerable pressure to do so.

Suppose, for example, that tuition charges rise rapidly for several years. The ease of financing through direct lending could have a part, if perhaps only a small part, in such a trend, and the Department might be pressured to do something about it as a responsible party. One or another kind of price control might be attempted. If this sounds implausible, consider that the statutory methodologies already place limits -- price ceilings -- on allowable subsistence costs in some cases. Ceilings on allowable instructional costs would be but the next step.

Federal controls on such costs could, of course, produce a nightmare of distortions. It would be far better to leave efforts to control instructional costs

to the states as part of their responsibility for public institutions. It is hard to imagine a world in which the states did their budgeting job really well and there was not also effective restraint on private institution and proprietary school costs as well as those of public institutions. Because Federal funds will provide loan capital in the direct lending program is not a good reason for a heavy-handed Federal role in cost control.

Another temptation the Federal government is likely to face is to "sweeten" student loans or some category of loans if repayment burdens are seen as too onerous. Various interest rate adjustments, deferments and forgiveness provisions could look very attractive if there turns out to be considerable numbers of borrowers who have borrowed too much or feel they have borrowed too much.

Borrowers have already been offered modestly lower interest rates as a benefit of direct lending. It is hard to see how rates could be reduced much more without incurring real costs to the Federal government, in effect reducing funds available for grants and payment alternatives like National Service.

Another kind of temptation is to add new prohibitions and accountability requirements to combat each abuse as it is discovered. For years this was the practice of the Guaranteed Student Loan program. Eventually, there were regulations to prohibit scams no one had heard of for years, least of all the people in banks and student aid offices who had to live with the requirements.

As abuses emerge -- and they will -- it is much better to step back from the particular scheme and ask what the incentives are that give rise to it, and then to think through an arrangement of incentives that will make such schemes not so much illegal as generically unattractive. The launching of the direct loan program could be the occasion for a new and better kind of regulatory oversight, which would, after all, be one way of "re-inventing government". A leaner kind of administration could result, with the Department's personnel more available to concentrate on issues of importance in reaching program goals.

Proprietary Schools and Direct Loans

Richard W. Moore

Abstract

This paper examines the unique characteristics of proprietary schools which set them apart from traditional institutions of higher education. It analyzes the potential pitfalls raised by these differences for the success of the U.S. Department of Education's Direct Loan program. Finally the paper raises a number of issues that need to be considered in the evaluation of Direct Lending in the proprietary sector.

Proprietary Schools and Direct Loans

Federal Student Aid policy shapes the behavior of proprietary schools more than any other force. Virtually all proprietary schools enroll at least some students who receive Federal student aid. Nationally, 79% of all proprietary students receive some Federal aid, compared to 29% of all students (Frass, 1990, pg.7). In some schools, up to 90% of the student tuition is paid by Federal Student Aid. Changes in Federal student aid eligibility policies were largely responsible for the proliferation of proprietary schools in low income, inner-city areas in the 1970's and 1980's. The availability of Federal student aid and the profits produced by enrolling aid-eligible students are primarily what fueled the rapid expansion of the proprietary sector in the 1980's and enticed many entrepreneurs into the sector.

On the other side of the equation, the fraud in student aid programs, combined with high default rates on guaranteed student loans and low completion and placement rates for low income students receiving Federal aid, triggered the continuing scandal within the sector. Recent changes in student aid policy, particularly in the area of guaranteed student loans, are largely responsible for the rapid contraction of the sector in the 1990's and the virtual disappearance of proprietary schools from inner-city areas in cities such as Los Angeles.

After a period of explosive growth in the 1980's, the proprietary sector is in a period of unprecedented turbulence. Schools are rapidly shifting their business strategies in response to the new Higher Education Act and the regulations that enforce it. Access to student loans has dried up for many schools with high default rates, and other schools have voluntarily left the program out of fear that a high default rate will eliminate them from other student aid programs, particularly Pell grants. The number of accredited schools, eligible to participate in Federal student loans, is in sharp decline. For example, after years of growth, the number of schools accredited by the Accrediting Commission of Independent Colleges and Schools (ACICS) has declined from 1,022 in 1989 to 755 in 1992, a decline of 26%, according to ACICS. Most of these schools were "high default schools", located in urban areas, who either lost their loan eligibility because of high defaults or were unable to find lenders willing to lend to their student because of high defaults. Some simply closed up before they lost eligibility or loan access. Several large chains of

schools such as United Education and Software have gone into bankruptcy and closed a large number of campuses.

At the same time that the sector was shrinking, the national groups that represent and accredit the proprietary sector were reorganizing. First, the Association of Independent Colleges and Schools, which included most business schools, and the National Association of Trade and Technical Schools joined to form the Career College Association. These two groups had historically served both as accrediting groups for their members and as associations advocating for the sector. In 1993, after the merger, the two organizations, the Accrediting Commission of Independent Schools and Colleges, and the Accrediting Commission of Trade and Technical Schools, were spun off as independent groups with no formal ties to the Career College Association, which is now strictly an industry association. How these newly independent groups will deal with the expanded role for accrediting bodies proposed by the Department of Education, particularly taking some responsibility for regulating defaults and evaluating the cost of instruction (Leatherman, 1993), is unclear.

Even in more stable times the proprietary sector has generated a host of unintended consequences for Federal student aid policies. Predicting the likely consequences of direct lending in the proprietary sector, given the turbulent context into which it will be launched, is difficult indeed. In this paper I will present the unique characteristics of the proprietary schools which separate them from traditional institutions and which may influence the implementation of direct lending within the sector. Next, I will identify some potential pitfalls for direct lending within the sector. Finally, I will identify issues that need to be considered in the evaluation design for direct lending in the proprietary sector.

Hardy Weeds In the Garden of Academia

Despite their marginal position within the higher education hierarchy, proprietary schools have survived and thrived since colonial times. The characteristics that make them so resilient as a group also make their behavior difficult to predict, and hence make policy development for the sector risky.

Proprietary schools are a paradox, part private business and part educational institution. As profit seeking organizations, the schools are extremely dynamic. The sector as a whole is perpetually in flux. Just getting an accurate count of schools is close to impossible. Schools open and close daily. They enter and leave the student aid system constantly. Schools and entire chains are bought and sold in a brisk market. Schools branch, merge with others and close rapidly, new programs are added, and existing programs are dropped frequently, all in response to market demand.

Rather than enroll students every quarter or semester, the schools have "starts" every four or six weeks. The schools run year round, with day, afternoon and evening session to maximize the use of their facilities.

Even within large school chains, management is highly decentralized, local school directors are given a high degree of autonomy, and individual schools are treated as independent profit centers. Schools within the same chain must conform to varying state regulations, if they operate in different states, and they also must respond to local market conditions creating significant variation between schools. Schools may be owned by an owner operator who is in the school every day, by a high flying entrepreneur, or by a large publicly traded corporation, with each owner bringing a different management style and set of priorities to the school's operation.

As profit seeking businesses, the schools relentlessly seek more efficient, lower cost arrangements for delivering services, particularly financial aid. The sector is served by an army of consultants and is quick to respond to innovations. For example, when the electronic Pell application and transfer of funds became available, the proprietary schools and the financial aid consultants who serve them were disproportionally represented among the early users of the system. The schools saw opportunity to speed up their cash flow to reduce operating costs, and they seized it.

Proprietary schools do not receive public funding, other than student aid, and do not raise funds from foundations or alumni; hence they are more dependent on student aid for revenue than any other sector. A higher proportion of students receive aid in the proprietary sector than in any other. Because of their dependence on student aid, proprietary schools are acutely sensitive to shifts in student aid policy. Maintaining eligibility for student aid shapes everything a school does, from its admissions policies, to its program length, to the location of the school. Thus in shaping student aid policy, policy makers shape the proprietary sector. For example, prior to the Higher Education Act of 1972, proprietary students were not eligible for most Federal aid. At that time, the proprietary school business principally served students who could pay for training out of their own pockets. Thus schools targeted people who were affluent enough to pay for training, and located schools in areas easily accessible to these groups. When the availability of student aid made it profitable to serve disadvantaged students, proprietary schools began to target their programs, marketing and locations to reach aid-eligible population groups. This created a explosion in the number of schools in the inner-city and in the number of disadvantaged students in the sector.

Proprietary students default on student loans at a much higher rate than students in other sectors. While there is a continuing controversy over what the real default rates are, due to various methods for calculating them, there is no question that proprietary students default more often. A recent default rate calculation for SLS borrowers who should have begun repaying in 1990, (known in the parlance of financial aid as a cohort rate), found that the overall

default rate was 22%, up slightly from 21.4% in 1989. For proprietary students the rate was 41.2%, up from 35.5% in 1989. The rate for public two year college students was less than half the proprietary rate, 17.3%. Four year colleges had a rate less than a quarter that of proprietary students, 7% for public four year colleges and only 6.5% for private four year colleges (DeLoughry, 1992). Despite the higher default rate in the proprietary schools, it is not clear that the proprietary schools themselves are the cause. A large scale study of defaults in California community colleges and proprietary schools found that after accounting for student characteristics, attending a proprietary school had only a marginal impact on the likelihood that a student would default (Wilms, Moore, Bolus, 1987).

Regardless of the cause of defaults, proprietary schools are feeling the pinch of reduced loan access as lenders and guarantee agencies move to reduce the default rates in their portfolios. Because of proprietary's dependence on student aid funds and diminished access, student aid policy now has a more powerful, if less predictable, impact on the behavior of proprietary schools than in the past. Finally, proprietaries are not linked institutionally to the rest of higher education. While most traditional institutions are accredited by one of six regional accrediting groups, proprietaries are usually accredited by one of four national accrediting groups that specialize in the proprietary sector. At the state level, proprietary schools belong to associations that are made up solely of proprietary schools. Most proprietary school directors and managers, such as financial aid directors or admissions directors, do not belong to the professional associations that serve similar professionals in traditional institutions. Also, since they are so small, many proprietary schools do not have professional, college-educated financial aid officers. Many schools rely on aid processing services to process applications and package aid. Others have processing done at a central location within the chain, or at another institution within the chain. In schools that do their own packaging, the financial aid officer may be a clerical worker who has been trained on the job.

Potential Pitfalls for Direct Lending

Based on the history of other Federal student aid programs in the proprietary sector, I see four broad areas where problems may emerge: the consequences of restoring access to loans; consumer information in proprietaries; meeting the logistical needs of proprietaries; and the limits of income contingent repayment.

Restored Access

Proprietary school associations have endorsed direct lending not because they want to see the Federal government play a more direct role in the program, but because they believe it will restore access for their students. School owners assume that as long as they stay below the default rate thresholds in the Higher Education Act, their students will be able to secure loans. The risk

of being without a private lender who will lend to their students will disappear. The owners are also hopeful that with the new system of electronic transfer of funds, loans will be funded more quickly and in general the school will be able to move students through the financial aid process and into the classroom more rapidly.

Assuming these changes occur and access is restored, a number of likely consequences loom. First, restoring access to schools and students who have lost it because banks and guarantee agencies didn't want to risk adding them to their portfolio means that the rate and number of defaults are likely to rise quickly and significantly. The schools and students that have lost access are those that serve the most disadvantaged populations who are most likely to default. These schools will likely move quickly to regain access through the direct lending option. This process will be facilitated by financial aid processing firms who will quickly handle required paperwork and put the technology in place to allow even a small cosmetology school with a handful of borrowers to participate.

As Martin Kramer notes in his paper (Kramer, 1993), streamlining the loan application process will increase the incentive to borrow and may drive up the price of education. This seems particularly likely in the proprietary sector for two reasons. First, these for-profit institutions are always seeking ways to increase profits and raising prices is a common strategy. Second, changes in the higher education act are causing a large proportion of proprietary schools to increase their program length to meet new standards in the Higher Education Act and to remain eligible for student aid. This drives up costs, which will ultimately mean increased tuition, some of which will paid for with loans.

Improved access also means new opportunities for fraud and abuse. While most school operators are honest and ethical, the profits available in the sector inevitably will tempt a marginal school owner or financial aid officer. Giving schools more autonomy in originating loans reduces the checks and balances provided by the lending institution, and thus increases the risk of fraud.

Consumer Information

As Baum (1993) points out in her paper, all students and their families are not equally in need of consumer information. Older students and students from more affluent families may have a clear understanding of the risks and trade-offs involved in borrowing for training. They may understand the obligations of borrowing and the consequences of failing to repay. But proprietary schools serve a large disadvantaged population who have little experience with credit. Many students have no credit history and may come from families where English is not the first language. Unethical admissions people and school owners may have incentives to downplay the obligations that the student is taking on when he or she borrows. Proprietary school students are usually

only in school six to twelve months, so the period available to educate the student about borrowing is limited.

For all these reasons, consumer education efforts in the proprietary sector will have to be more intense. As Baum recommends, information needs to be brief, to the point, and offered frequently. The proprietary sector has developed a number of "default prevention programs" that feature accessible materials including videos, pamphlets, posters and scripts for orientation sessions. These materials will have to be redone to reflect changes in the program. In addition, to the degree the Department of Education produces materials, they may want to produce them in additional languages to reach non-English speaking or limited English speaking parents and students.

Finally, as noted before, proprietary school staff are unlikely to be part of the usual professional associations. Special efforts to reach proprietary financial aid officers and admissions directors will have to be made through the Career College Association, proprietary accreditation groups, and state level proprietary associations.

Logistical Issues

Proprietary schools' frequent enrollment periods mean that they will use the direct loan system constantly during the year rather than two or three times before the start of each semester or quarter. The small size of most proprietaries, plus the large number of schools, means that they will be drawing down small amounts of money frequently, potentially increasing administrative costs. In addition, the system will need to accommodate rapid expansion and contraction in the number of proprietary campuses participating, as the sector moves through cycles of expansion and contraction. Also, proprietaries will change their originator more often than traditional institutions, especially in the beginning of the program when operators are seeking the most efficient way to process loans and consultants are competing to establish themselves. As individual schools are bought, sold or merged, their originator may change. All these phenomena will cause churn within the system and potential problems for tracking borrowers and for holding originators accountable.

Effectiveness of Income Contingent Repayment

If a primary goal of income contingent repayment is to reduce defaults, the outline of the proposed system while still incomplete, may do little to stem the high rate of default in the proprietary sector, because it will do little to reduce the repayment burden of the typical defaulter.

The typical defaulter, as several studies have shown (see Wilms, Moore and Bolus, 1987), is a dropout who borrowed once and whose earning prospects are dim at best. Take for example a proprietary student in a secretarial program who drops out and owes $2,000. Her monthly payment will be only

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about $14, yet she is still likely to default. Even if she only works half time, at $5.00 per hours she will earn $400 a month, and an income-contingent repayment programs that allows borrowers to reduce their payments to 10% of their income which in her case would be $40. With her poverty wages and lack of experience with borrowing, she remains very likely to default. Again, increased access from direct lending is likely to bring more people like this into the system. As the specifics of the income contingent repayment plan are developed an option aimed at this typical defaulter must be included, if the plan is going to prevent defaults.

Evaluation Design Issues

The unique character of proprietary schools raises a variety of issues that must be addressed in the evaluation design for direct lending.

Sampling

Choosing the pilot group of proprietary schools for the first year of direct lending is particularly problematic. Schools that have lost access to private lenders or who believe they are in danger of losing access will have powerful incentives to apply. Thus, the pool from which the sample will be drawn is likely to be atypical of the sector as a whole. It is likely to include schools that serve a large proportion of disadvantaged students even by the standards of the proprietary sector.

Careful sample selection can correct for many potential biases. To select a representative sample the population of schools that applies for the first year of direct lending must be stratified and weighed against the universe of proprietary schools participating in student aid programs. Stratification must be done on variables which may not be considered in other sectors. Variables that need to be included in the stratification design are shown in the following table with a brief explanation of their importance.

Sample Attrition and Change

As noted earlier the proprietary sector is far more dynamic than traditional sectors. Over the course of the pilot some schools will close, merge or branch. The evaluation design must decide how these behaviors will be treated. Will closed schools be replaced? Will their borrowers continue to be included in the pilot? If schools merge or branch will the new institution be added or will those groups be dropped?

Variables for Stratifying The Proprietary Sample of Schools For Direct Lending Evaluation

Variable	Levels	Rationale
Accreditation	ACICS* ACTTS NACCAS ACCET ABHCS Regional	Schools within different accrediting groups tend to be relatively homogeneous in terms of program offerings, and student characteristics. For example, ACICS schools principally offer business programs; most of their students are women; most ACTTS schools offer trade/ technical programs; most of their students are men; all NACCAS schools offer cosmetology programs; their students tend to be younger than other groups.
Size	Group in quartiles	Schools size varies widely from a few dozen to thousands of students and often stands as a proxy for administrative complexity and sophistication. Size is also intercorrelated with accreditation; NACCAS schools tend to be small, while ACTTS tend to be large.
School Organization	Chain vs Independent and Branch vs. main campus	Schools which are members of school chains or groups often operate differently from single site, owner operated schools. For example, financial aid processing may be centralized in chains, and not done at the local school. Also researchers need to consider if, when a campus is selected, its branches are included.
Type of financial aid processing.	Processing at school site. Processing at central location or other school. Processing by consultant.	How a school has chosen to process its aid applications is a key variable in how they will manage direct loans. If a school which processes aid for other campuses is selected will the other campuses be included?
Default Rates	Quartiles	Default rate is a proxy for student demographics and possibly other school characteristics. Since high default schools will have an incentive to apply for the pilot, it is crucial that the sample have the same distribution of default rates as the overall population.

*ACICS is the Accrediting Commission of Independent Colleges and Schools, ACTTS is the Accrediting Commission of Trade and Technical Schools, NACCAS is the Accrediting Commission of Cosmetology Arts and Sciences, ACCET is the Accrediting Commission of on Continuing Education and Training, ABHCS is the Accrediting Bureau of Health Career Schools.

Changes in Processing

During this period, proprietary schools will act aggressively to find the most efficient way to process direct loans. During the course of the pilot, they may change how their loans are processed. A school may cease processing its own loans and hire a consulting firm, or a school that is part of a chain may move from processing its own loans to having them processed at a central location within the chain. Other unanticipated practices, which will affect how the program is administered, are likely to emerge.

It is crucial to the success of the evaluation that these changes be documented and included in the analysis. These new practices may include innovations which could improve the overall program. Conversely, innovations may mask ways of exploiting loopholes in regulations. In any case, some degree of field work must be built into the evaluation design to track and document the new practices that emerge.

Measuring Access and Interpreting Loan Volume

Since so many proprietary schools have lost or are in danger of losing access to private lending, a quick spurt in loan volume among schools in the pilot group should be anticipated. Restoring loan access to good quality schools in which it has been lost or constrained should be viewed as a positive outcome. On the other hand, rapid increases in loan volume at an individual campus may be a warning sign that warrants investigation. Many of the worst abuses documented in the 1980's occurred when an unethical school owner began rapid expansion by branching, acquiring schools, or increasing enrollments through deceptive or high pressure sales techniques. This usually led to a huge increase in loan volume, followed by a corresponding increase in default costs. The evaluation plan should include establishing a baseline level of lending and then track loan volume school by school. Schools which show explosive growth in volume should be investigated immediately to determine the cause of the growth. In addition, the design should track the average amount borrowed and tuition costs at the school level to determine if easy access is encouraging schools to have students borrow more and if loan availability is pushing up tuition costs.

Understanding and Interpreting Patterns of Default

Direct lending is likely to increase default rates in the proprietary sector in the short run, as schools serving high risk populations regain access to lending. Again, this may not be a negative outcome, if the goal of the program is to keep loans available to the most disadvantaged segments of the population. The problem with measuring defaults is determining how much is too much. A suburban school with a middle class clientele should not have a default rate of 25 percent unless it is failing to deliver training which leads to employment

or doing a very poor job of administering the program. Conversely, an inner city school serving an extremely disadvantaged population could be justifiably proud of a default rate of 25 percent.

I would suggest that as part of the evaluation design the evaluators calculate a predicted default rate for participating schools based on the demographics of their aid recipients and contrast the predicted rate with the actual rate. Previous research (Wilms, Moore, Bolus, 1987 and Knapp, Greene and Seaks, 1992) shows that demographics are reliable predictors of defaults. Based on data from the student aid applications, evaluators could calculate an expected default rate for a given cohort at each school, with some confidence band. If a school's default rate rose too far above the expected rate, further investigation would be warranted. Conversely, if a school's default rate was significantly below the expected rate, further investigation would be warranted to see what practices are producing the low default rate and if they might be replicable.

Summary

Policy makers and evaluators must consider the unique characteristics of proprietary schools as they implement and evaluate the direct loan program. At the policy level, restoring access to schools who have been squeezed out of the system may have immediate consequences for the loan volume and the default rate. The dynamism of the proprietary sector may also give rise to a host of unintended consequences for direct lending, which policy makers will need to anticipate and mitigate. Effective consumer education will be more difficult to achieve in the proprietary sector because of the disadvantaged character of the students it serves and the short time students are in school.

The unique characteristics of proprietary schools also raise significant issues for evaluators. Evaluators need to recognize that research designs aimed at traditional institutions may prove fatally flawed in the proprietary sector. The current plan for soliciting institutions for year one may already yield an atypical cohort of schools. Careful sampling and significant field work will be required to evaluate direct lending in the proprietary sector.

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Summary of Student Loan Reform Act of 1993

Projected Effects on Guarantee Agencies

Peter Keitel

On August 10, President Clinton signed the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) which includes the Student Loan Reform Act of 1993. The Act includes the phase-in of Federal Direct Lending, significant changes in the Federal Family Education Loan (FFEL) program, and assessment of a new statewide default penalty fee on states. This paper discusses the impact of these changes on the New York State Higher Education Services Corporation (NYSHESC) as well as other guarantee agencies in general.

Direct Loans

The Act provides for an increasing percentage of new student and parent loan volume to be shifted to Direct Lending over the next five years. For academic year 1994-95, only 5 percent of the new loan volume will be made through Direct Lending. That percentage will then increase to 40 percent in 1995-96; to 50 percent in both 1996-97 and 1997-98; and to 60 percent after that. The percentage could be higher in the last three years if additional schools volunteer to participate.

Despite the advent of Direct Loans, there will be a significant near-term increase in FFELP volume because of changes in loan limits enacted by the 1992 Amendments to the Higher Education Act. When Direct Loan volume reaches 60 percent of total loan volume, NYSHESC's loan volume will be 25 percent less than in the recent past (1991-92). The following table shows the projected loan volume for NYSHESC as the Direct Loan Program is phased in:

NYSHESC Loan Volume Projections*
For FFY 1991 through 1998
(in millions)

Federal Fiscal Year (Academic Year)	Direct Loan Phase-in Targets	Estimated NYSHESC Volume
1991 (1991-92)	-	$1,106**
1992 (1992-93)	-	1,309**
1993 (1993-94)	-	1,632
1994 (1994-95)	5%	1,652
1995 (1995-96)	40%	1,080
1996 (1996-97)	50%	946
1997 (1997-98)	50%	988
1998 (1998-99)	60%	830

* Based on Congressional Budget Office Projections of national loan volume.

** Actual

Language was included in the final Act which requires the U.S. Secretary of Education to give state agencies with proven experience preference in awarding contracts for the servicing of the Direct Loan Program. This language (underlined) was added to the "contracting" section of the bill in response to a NYSHESC initiative to insure a role for state agencies in the new program and now reads as follows:

> "...In the case of awarding contracts for the origination, servicing, and collection of loans under this part, the Secretary shall enter into contracts only with entities that have extensive and relevant experience and demonstrated effectiveness. The entities with which the Secretary may enter into such contracts shall include, where practicable, agencies with agreements with the Secretary under sections 428 (b) and (c), if such agencies meet the qualifications as determined by the Secretary under this subsection and if those agencies have such experience and demonstrated effectiveness. In awarding contracts to such state agencies, the Secretary shall, to the extent practicable and consistent with the purposes of this part, give special consideration to state agencies with a history of high quality performance to perform services for institutions of higher education within their state."

A group of state agencies is working together to help define the manner in which these agencies will be able to participate in the Direct Loan Program. The agencies have drafted a paper that outlines the advantages of using these existing resources and makes recommendations on how they can be integrated into the Direct Loan Program.

Federal Family Education Loan Program Changes

Guarantee Agency Changes

The 1993 legislation has a very substantial impact on guaranty agency finances. The viability of agencies has become an issue within the higher education community. Recently 21 guaranty agencies wrote to Secretary of Education Riley regarding financial problems caused by the new law expressing concerns over the "imminent failure" of guarantee agencies.

Several provisions included in the Act change and reduce Federal administrative funds to guaranty agencies such as NYSHESC. These include:

1. The insurance premium paid by students on their loans can be no more than 1 percent. NYSHESC currently charges students 1.5 percent and will, therefore, lose one-third of its current insurance premium income.

This change becomes effective with loans guaranteed on or after July 1, 1994.

Although NYSHESC will experience an increase in insurance premium income in the near future because of increases in loan volumes, the Agency will lose approximately seven million dollars in 1994-95.

NYSHESC has historically charged the lowest insurance premium possible and at present is charging only 1.5 percent. Reducing the insurance premium rate to 1 percent is not as significant a loss for NYSHESC as it is for most agencies. In addition to that, the income from the insurance premium represents a relatively small percentage of our operating costs--25 percent. By reducing from 1.5 percent to 1.0 percent we lose only 1/3 of our insurance premium income or 8 percent of our operating costs. Agencies that are charging as much as 3 percent and where the insurance premium constitutes a larger portion of their operating costs are facing a loss equal to 25 percent or more of their annual operating costs.

2. The percentage of default collections that guarantee agencies are allowed to retain dropped from 30 percent to 27 percent effective October 1, 1993, on all collections.

   The loss in the portion of collections that can be retained by guarantee agencies will have little effect on NYSHESC. Because we invested in an automated Debt Management Collection System (DMCS) several years ago, our collection operation is much more efficient. We are now able to increase collections with no increase in staff. The increase in collections bolstered by DMCS along with no need to increase staff this year or next year will cover most of the loss from changing the percentage of collections that may be retained from 30 percent to 27 percent. While we will lose 10 percent of our collections revenue, for this year collections are up 7.1 percent.

3. Both the amount of default insurance to the lenders and reinsurance by the Federal government for guarantee agencies will be reduced to 98 percent for loans where the first disbursement takes place on 10/1/93 or later.

   Even though the reinsurance drops by a full 2 percent, there are several factors which mitigate this significant loss of income. To begin with, the loss will not occur for several years after loans guaranteed on or after October 1, 1993, begin to go into default. At NYSHESC, defaults are now declining, so we should have fewer that need to be reinsured. In addition, the reduction will not apply to Lender of Last Resort Loans.

4. The administrative cost allowance is repealed effective July 1, 1994, but will likely be replaced by a payment equivalent of 1 percent of loan approval volume to help defray administrative costs. For FY 1995 the Education Department has announced that it will pay an (Administrative Cost Allowance (ACA) that is equal to one percent of loans guaranteed.

5. The law changes the payment of Supplemental Preclaims Assistance from $50 per loan to 1 percent of the unpaid principal balance and accrued interest on the loan where the delinquency is resolved up to the 270th day of delinquency and a claim is not filed. This provision is also effective 10/1/93.

6. Recovery of Reserves - The Secretary is authorized to recover reserves and any assets purchased with reserve funds regardless of who holds or controls the assets or reserves.

Some of the changes included in the Act will either increase income or decrease costs for NYSHESC. For example, the reinsurance fee was eliminated effective 10/1/93, and the Agency will be able to charge an insurance premium on unsubsidized loans effective 7/1/94. The previous law prohibited guarantee agencies from doing so.

There is nothing in the changes to the law on the financing of guarantee agencies that has a sudden and devastating affect on agencies. While weak agencies will be made weaker, strong agencies will not be suddenly debilitated. The changes will generally cause a slow drain in reserves. The effects will vary among agencies. Agencies with a combination of high insurance premiums, high expenses, and high defaults will be most seriously hurt.

Some agencies may give serious consideration to the question of whether or not to continue to guarantee new loans after July 1, 1994. As of that date insurance premium income will decline substantially for a number of agencies. The reduction in the insurance premium can result in there being insufficient income on new loans to cover the long term costs of those loans. Agencies will be faced with the prospect of having to fund new loan volume from the reserves that were established on older loans. Thus, some agencies will see continued participation in the FFEL Program as hastening their decline.

At NYSHESC, we have made projections out as far as 1998 which show us in a very stable financial condition and are currently working on models to be able to project further into the future. As we develop the models and refine our projection techniques, we will be better able to predict effects on NYSHESC and then make appropriate adjustments to accommodate those effects. At this point in time it appears that reasonable cost containment

measures will be sufficient to keep NYSHESC in a stable financial situation well into the next century.

Changes Related To Lender of Last Resort Programs

1. Lender Referral Services - Requires the Secretary to pay a 1/2 percent referral fee to agencies which provide a Lender Referral Service to eligible students.

2. Lender of Last Resort - Amends the rules and operating procedures for Lender of Last Resort programs to prohibit a guaranty agency from developing rules and operating procedures which require the student to meet eligibility requirements above what is required by the statute or be required to receive more than two rejections from eligible lenders. Lender of Last Resort applications submitted by a student must be responded to within 60 days. The Bill also removes the HEA 1992 provisions which stated agencies did not need to make LLR loans available to schools with cohort rates in excess of 25 percent, had not participated in the FFEL Program in the past 18 months, or are currently subject to LS&T. The Secretary is authorized to make advances to an agency for the agency to make Lender of Last Resort loans. Upon assignment, the portion of the loan advanced by the loans assigned to the Secretary shall be considered to be repaid.

3. The Student Loan Marketing Association is required to serve as Lender of Last Resort in certain designated geographic areas. Loans made can be insured by the Secretary or a guaranty agency.

In the past, Lender of Last Resort programs have been small. The programs have dealt with the highest risk students and schools and there simply has not been much desire or incentive to make these loans. The default reinsurance structure and the administrative costs associated with loans to students with high default rates have constituted a strong disincentive. The changes in the law, particularly the provision for 100% insurance and reinsurance, are likely to bring about a different attitude toward LLR programs. For example, if all proprietary school loans are made through LLR programs, both lenders and guarantee agencies can significantly reduce the losses that they would otherwise experience. It is not inconceivable that LLR volume could reach twenty to thirty percent or more of total loan volume.

Other Significant Changes for Students and Lenders

Emergency Advances to Guaranty Agencies - The Secretary is authorized to issue Emergency Advances to Guaranty Agencies: (1) to support the agency in making Lender of Last Resort loans; or (2) in order to meet the agency's immediate cash needs and ensure uninterrupted payment of default claims if the Secretary is seeking to terminate an agency's agreement or seeking to assume the agency's functions.

State Risk Sharing

The new law requires states to pay to the Secretary a fee calculated based on a formula in the law if there are any schools in the state which have a cohort default rate in excess of 20 percent. The fee is effective with FFY 1995, and the assessment rate increases until FFY 1997.

The fee that would be charged to New York State based on the latest cohort default rates is $8-9 million. Federal law authorizes states to charge a fee to the schools that are the cause of the fees charged to the states. However, there are several problems with this. The states will have to set up a structure to collect the fees, and this will take time. Schools with high default rates frequently close, and it may not be possible to levy the fees on the schools that have the highest default rates. In order to escape paying fees to states, high default rate schools will have an incentive to join the Direct Loan Program.

Issues in How Federal Student Loans will Be Repaid in the Future

Arthur M. Hauptman

This paper has been adopted in part from a paper entitled "Thinking About Next Steps in Federal Student Aid Reform" prepared previously for the Brown Education Policy Center at the Brookings Institution.

During the 1992 campaign, candidate Bill Clinton proposed that all student borrowers should be able to repay their loans on an income contingent basis through the Internal Revenue Service. That the Federal government rather than the private sector would finance student borrowing through the mechanism of direct loans was a secondary theme in the campaign.

Once the Clinton Administration took office, the focus on how Federal student loans might be reformed shifted from how they would be repaid to how they would be financed. As a result, the debate leading up to passage of the Student Loan Reform Act of 1993 focused almost entirely on the issue of direct loans.

Whether student loans in the future should be repaid on an income contingent basis was dealt with in the 1993 legislation primarily on a conceptual basis. The legislation provides a framework which specifies that all Federal student loan borrowers in the future should have the option to repay on the basis of their income, but that most borrowers would not be required to do so. The legislation also provides that the Secretary of Education may require borrowers in default or in danger of default to repay on an income contingent basis.

The 1993 legislative debate focused on direct loans primarily because they were estimated to save more than $4 billion over five years, while proponents of income contingency were unable to convince the budget scorekeepers that it was a budget saver.

Since the budget reconciliation procedures require that provisions could not be taken up unless they cut spending, income contingency ended up taking a back seat to direct loans in the formulation and debate over the budget legislation. The Administration also focused on direct loans because it perceived (accurately) that direct loans had a much better chance for legislative passage than full-blown income contingency.

Now that the student reform legislation has been enacted, the principal decisions to be made with regard to student loan repayment in the future are: First, should all student borrowers be required to repay through the Internal Revenue Service, or should most of them continue to repay as they do now through private servicers on an amortized (equal payment) basis?, and Second, how should various repayment options ,including income contingency, be structured?

This paper examines these two questions. To provide some context for this discussion, comparisons are drawn, where applicable, to the experience of the limited number of other countries in which income-contingent student loan repayment systems have been instituted in recent years, including Sweden, the United Kingdom, Australia and New Zealand. In addition,

Canada has some income contingent proposals under active consideration which merit our attention in this country.*

Possible IRS Involvement in Student Loan Repayment

The 1993 student loan reform legislation requires the Administration to prepare a report (within six months of passage of the legislation) on what role, if any, the Internal Revenue Service should play in the servicing and collection of student loans. One issue to be addressed in the Administration's report is whether the IRS should be responsible in the future for the servicing and collection of all Federal student loans.**

Deciding the future role of the IRS in student loan repayment hinges on several other decisions, however. For example, if the 1993 legislation had required all future student loan borrowers to repay on the basis of their income once they completed their education, then the IRS would be the only logical candidate for student loan servicing and collection. The costs and complexity of administration and data transfer entailed in having some other organization collect income information on all student loan borrowers would be prohibitively expensive.

Similarly, if direct loans eventually account for all Federal student loans in the future, then the case for IRS collection would be much stronger than if the private sector continues to be the source of at least some portion of student loan capital and remains responsible for servicing some loans in repayment.

But since the 1993 legislation limits income contingency to a portion of the borrower population and provides that the private sector will continue to provide some student loan capital at least through 1998, then several other options besides the IRS need to be considered regarding who services and collects student loans.

The principal argument for having all student loan borrowers repay through the IRS is that the Federal costs of student loan defaults, which now amount to more than $3 billion annually, could be radically reduced. Some of those who advocate full-blown income contingency through the IRS have claimed that defaults would be eliminated entirely. This assertion, however,

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* Information on the income contingent programs in these other countries is drawn from "An Overview of Student Financial Assistance in Four Countries: A Background Document for the AUCC Standing Advisory Committee on Funding", Association of Universities and Colleges of Canada.

** In the parlance of the banking industry, the term servicing typically refers to activity on loans in good standing, whereas collection is related to actions on delinquent or defaulted loans.

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overlooks the fact that some borrowers simply do not have the income necessary to meet their repayment obligations. It also ignores that some student loan borrowers will figure out how to game the IRS system, just as happens in the course of normal tax collection. A more realistic assessment . . . would seem to be that defaults or nonpayment of student loans would be cut by at least one-half from current levels through systematic involvement of the IRS.

Another argument for total IRS involvement in student loan repayment is that it would simplify the process for many borrowers and administrators who under the current approach have to deal with a multitude of private loan servicers. Under the current privately-financed system, borrowers often find themselves making repayments to several loan servicers who hold or are responsible for servicing the student loans they borrowed from different lenders.

Perhaps the strongest argument against requiring all student loan borrowers to repay through the IRS is the fact that even at current high default rates, roughly 4 in 5 borrowers repay promptly and completely. Those who argue against total IRS involvement in student loan repayment ask whether it makes sense to require all borrowers to repay through the IRS when a majority of student loan borrowers are perfectly capable paying on time. Nor should policy makers underestimate the level of public resentment that might be directed at having to pay student loans through the IRS. An extension of this argument is why not also make car payments and mortgages through the IRS.

Another important consideration is whether the IRS has the capacity to service and collect millions of students loans every year. On the surface, this seems like a silly question, given that the IRS collects taxes from tens of millions taxpayers every year. But in many ways, collecting taxes is an easier job than collecting student loans. For example, the tax system relies heavily on employers to withhold based on a uniform rate schedule that meets the cash flow needs of both the government and of the taxpayer. This system works as well as it does because everybody is subject to the same schedule of withholding rates applied to income.

If the new student loan repayment system required the IRS to keep track of different withholding rates for individuals based on the amount they borrowed, this would substantially complicate the task of the IRS relative to what it does now. Some have argued that taking on the job of student loan collection could thereby entirely transform the role of the IRS and make it much more intrusive in what has been a largely voluntary system, even if it doesn't feel voluntary to most Americans on April 15th every year.

Another alternative is to limit the involvement of the IRS to those borrowers who need or desire income-based repayments, while leaving most other borrowers with a set of less radical repayment options with private loan

servicers. These less radical repayment options include: graduated payments, in which payments in the early years of repayment are lower than equal amortized payments with larger payments in later years when borrowers typically can afford it, and extending the maximum term of repayment beyond what has been the typical ten years.

The Federal cost consequences of these alternative repayment arrangements will differ between loans that were financed directly by the Federal government or privately. Extending the term of repayment on a direct loan, for example, is actually a Federal cost saver since the Federal government "profits" as the direct loan holder from the difference between costs and revenues. If that loan is held privately, extending the repayment term either has no Federal cost consequence or it could add to Federal costs as the loan principal would remain higher for a longer period of time, thereby committing the government to additional payments over time to the private sector loan holders.

There are also alternatives to the IRS even for those loans which are repaid on an income contingent basis. Banks and other private servicers, for example, could perform this function, although it would be problematic to have the IRS provide tax records to private sector organizations.*

Or the responsibility for administering income contingent repayments could reside with the state agencies which currently run a form of income contingent repayment when they negotiate to collect from borrowers who previously defaulted. These agencies are encouraged to contact the defaulter and get them to repay whatever amount it is determined they can afford.** The premise in this case would be to transform the current default-based state agency collection activity into one in which borrowers having difficulty making their repayments are offered assistance *before* they default rather than being hounded *after* they have defaulted.

Each of the other countries which have income contingent plans in place use their respective tax collection agencies to administer the collection of income contingent student loan repayments. But none of these countries require all borrowers to repay through the income tax system. In several cases, the

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* One way to deal with this privacy issue is for the IRS to match borrower reported information with its records, and then flag for further review those cases in which variances occurred.

** Under current arrangements, when a student borrower defaults, the bank or other private sector loan holder is directly reimbursed by the state guaranty agency. These agencies in turn submit a claim for reinsurance to the federal government but keep the bad loan paper and are encouraged to try and collect from the defaulter these state agencies get to keep 30 percent of what they collect on these previously defaulted loans.

amount of income that must be earned before any repayment is required is large enough so that many borrowers are not obligated to repay in any given year.

In Australia, for example, as much as one-fifth of the borrowers prepay their loans (at a discounted amount) and therefore never repay on an income contingent basis. For those borrowers who do not prepay, income-based repayments are required only for those who earn above the average income for college graduates. In the United Kingdom, most borrowers repay at a fixed rate, and for those on income contingent schedules, payments are deferred in any year when the borrower's income is below 85 percent of the average earnings. In other words, the tax collection agencies in these countries do not collect from many, if not most, student loan borrowers in any given year.

Other Repayment Issues

The 1993 legislation, as previously noted, establishes a conceptual framework that will govern the operation of income contingent repayments. For example, the 1993 legislation precludes cross-subsidization in which borrowers with relatively high incomes after they graduate would be required to repay more than they owe in order to subsidize low-income borrowers who cannot meet their repayment obligations. In addition, the 1993 legislation limits the maximum length of repayment to 25 years after which the remaining debt would be forgiven.

But a number of policy and operational issues still have to be resolved about the future structure of Federal student loan repayment regardless of what proportion of borrowers participate in income contingency and regardless of which organization administers these provisions. The remainder of this paper discusses some of these other income contingent issues, including:

- Should borrowers who do repay through the IRS make payments once a year through the income tax system or in the form of additional employer withholding throughout the year?

- What schedule of repayments will apply to income contingency? This question begets a number of related questions, including: Will a certain amount or proportion of income be ignored before student loan income-based repayment assessments are made? Will the rate of repayment be tied proportionally or progressively to income? Will it vary with the amount borrowed? Should other factors such as interest rates vary with the amount borrowed?

- Will interest be added to principal for borrowers whose income-based repayment does not equal the interest on what they owe, a situation referred to as negative amortization?

- Should all borrowers who do repay on an income contingent basis be subject to a single schedule of repayments, or should some degree of experimentation be built into the structure to test the utility and effects of different repayment schedules?

- Should only direct loan borrowers be eligible to repay on an income contingent basis, or should this option be available to borrowers in the privately-financed programs as well?

Lump Sum Payments or Employer Withholding

Relatively little of the sizable amount of what has been written over time on the issue of income contingency has focused on whether the payments should be made as part of the borrower's annual income tax payment or integrated into employer withholding, either through the income tax or payroll tax system. One exception to this statement is Robert Reischauer's HELP proposal in which he specifically argued for using the payroll tax as the basis for repayment because it would be built on the existing employer withholding system.

Another reason Reischauer advocated using the payroll tax system is that it only uses the income of the individual in determining tax liability. Thus, the many concerns with the student loan "dowry", where a spouse's income can affect student loan repayment levels, would not arise as they would if the income tax system were used.

This issue of what measure of income to use in determining the size of the borrower's annual payment is very much tied to the question of withholding versus lump sum. If payments are withheld on a periodic basis over the course of the year either through the payroll tax or the income tax, current year earnings would be the most likely measure of income used.

If, instead, payment is made on a lump sum basis as part of the annual income tax collection, then the question of which year's income and which measure of income become much more prominent items for discussion. My recommendation in this regard would be to use the previous year's income because it is verifiable and because any variation in the current year income will be captured through the next year's repayment under a multi-year income contingent system.

If proponents of income contingency had focused on the issue of *how* loans would be repaid, it seems obvious they would have come down on the side of

employer withholding. Asking borrowers to add thousands of dollars to their tax bill at the end of the year, with no provision for payment during the year, seems destined to add to default problems rather than lessen them. Employer withholding, which generates most of the Federal government's tax revenues, is predicated on this belief. Consistent with this thought, the countries that have income contingent repayment schemes in place, including Australia, Sweden, and New Zealand, seem to rely on employer withholding as the principal means of repayment.

But employer withholding for student loan repayment is not without its drawbacks. Employers of all sizes would not be pleased with having an additional responsibility placed on them, especially in light of their opposition to the Clinton Administration's employer mandate for health care reform. The opposition to student loan withholding will be especially keen if that responsibility entails being required to keep track of rates of withholding that vary according to how much the employee borrowed, thus greatly adding to the administrative complexity of the exercise.

This issue of tracking individual rates is also of concern to the IRS since the essence of tax withholding is that a single schedule applies based on the employee's income. These considerations suggest that a more effective and manageable withholding system for student loans would be one in which the sole variable to be tracked is the income of the borrower.

Several of the income contingent proposals now under discussion, including those of Representative Petri and Senator Simon, seek to minimize the burden on employers and the IRS by placing the responsibility on the borrowers themselves to meet their loan obligations. They suggest this could be done by having borrowers ask their employers to withhold additional amounts without requiring employers to track how much the borrowers owe.

This happens now in the current withholding system when employees request additional withholding on a separate line on the W-4 form. Student loan borrowers would know how much to have withheld through the issuance of a look up table. Under this approach, however, the IRS would still be responsible to keep track of whether amounts withheld met the income contingent obligations of the borrower.

The Schedule of Repayments

What most of the literature on income contingency has focused on in the past is the schedule of repayments that would be applied to participating borrowers. This attention in the literature to the repayment schedule was a function of a number of related concerns, including how to prevent adverse selection and what schedule of repayments would not require subsidies from the government.

The 1993 legislation precludes many of these concerns, however, by prohibiting adverse selection: It would not require well-off borrowers to repay more than what they owe in principal and interest. The legislation also assumes that some government subsidies will be needed to pay for borrowers whose income-based payments do not repay their loan obligations (These subsidies could be financed through the reductions in default costs resulting from keeping students in repayment who otherwise would have defaulted.)

Since the 1993 legislation eliminates at least several of the most contentious issues that typically have dominated discussions of income contingent repayment schedules, any discussion now of income contingency needs to focus on other considerations such as what constitutes a fair percentage of income that student loan borrowers should be asked to repay.

One of the debates over the years among income contingent aficionados has been at what point does student debt service as a percentage of income represent a hardship. Estimates of what constitutes hardship have ranged from debt service as low as 3 percent to as high as 15 percent of the borrower's gross income. A frequent compromise position has been that 10 percent of gross income represents an appropriate measure of hardship.*

Another design element in income contingent repayment is whether the rate schedule should be progressive or proportional. A progressive schedule has the ring of fairness, building on the principal logic underlying the Federal income tax schedule. But a number of good arguments can be made for designing a proportional income contingent rate schedule, including greater simplicity and predictability if borrowers know precisely what percentage of income they will be charged when they enter repayment.

It is also possible to develop a repayment schedule in which a single rate applied to a larger debt produces a more progressive amount of repayments than a progressive rate schedule applied to borrowers with lower debts. That is, progressivity can be achieved by applying a proportional rate to income tied to a progressive rate applied to the amount borrowed.

A related question is whether some amount or percentage of a borrower's income should be protected for basic expenses before a student loan repayment is expected. This feature adds some fairness to the system in that destitute or lower income borrowers would not be asked to repay their loans, but this fairness comes at the cost of either adding to the government subsidy

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* By happenstance, the annual payment based on the typical student loan repayment term of ten years and an interest rate of 7 or 8 percent comes to about 10 percent of what the borrower owes. Therefore, a reasonable rule of thumb for determining hardship in student loans is that if a borrower's debt exceeds his or her income, that is a sign of trouble.

level or requiring higher rates of repayment on income above the protected level in order to minimize the Federal government's cost exposure.

In terms of the repayment schedules used in other countries, Australia applies a progressive rate schedule that varies between 2 to 4 percent of income above the national average earnings level. Sweden and New Zealand, on the other hand, apply a single rate. New Zealand charges 10 percent of income above a threshold now roughly $13,000 of income, including while the borrower is still a student. Sweden charges borrowers 4 percent of their prior year income, but appears to be the only country in which no income threshold applies -- it expects student loan repayments from the first dollar of income. The United Kingdom has an interesting approach in that all payments are deferred for borrowers whose income falls below 85% of average earnings. But the UK apparently is considering shifting to a system in which a 2 percent surtax would be imposed for a borrower's entire working life.

Another critical issue in developing an income contingent repayment schedule is whether factors other than income should be included as part of the schedule, particularly how much the student borrowed. Typically, income contingent proposals call for repayments to vary per $1000 borrowed. The more that a student has borrowed, the greater the level of annual repayment for any given level of income. Interestingly enough, none of the other countries which has established income contingent programs bases the repayment on the amount borrowed.

One tradeoff with regard to factoring the amount borrowed into the repayment rate schedule was raised in the previous discussions of employer withholding and progressivity. Factoring the amount borrowed into the repayment schedule allows for a more progressive calibration than if the amount of repayment only varies on the basis of income.

But basing the annual repayment on the amount borrowed greatly complicates the task of employers and the IRS in keeping track of the rate that applies to individual borrowers. It is far easier administratively to apply a single rate schedule based on income in which the IRS or whichever other organization administers income contingency keeps track of how much of the debt has been repaid at any particular point in time.

Nor is varying the rate applied to income based on the amount borrowed the only approach that can be taken. Representative Petri's plan for income contingent repayment, for example, would take a different approach: his proposal would base income contingent student loan repayments on the income tax rate schedule that was in effect before the 1986 tax reform legislation.

I cannot do justice to the argument made for using the pre-1986 tax rate schedule that was largely developed by Joe Flader, Representative Petri's chief staff person on this issue and an unflagging advocate for many years of income contingency. But it is worth considering whether this alternative makes sense, if for no other reason that Joe Flader has spent more time thinking about this issue than any other person, living or dead, on the planet.

As an offshoot of the Petri/Flader approach, I would like to suggest the possibility of using **a percentage of borrowers' annual income tax liability** as the basis for their income contingent student loans repayment. While on the surface this may seem like a silly suggestion, I am suggesting it as a serious proposal. After all, a borrower's income tax liability includes all of the factors that one might want to include in the calculation of a student loan repayment obligation, including: a protection of basic expenses that varies by family size; a progressive rate schedule applied against family income; and taking into account other expenses that reduce discretionary income.

By applying a percentage against that tax liability, the percentage could be pegged to produce whatever net effective rate of repayment was desired. Bob Shireman, Senator Simon's chief staff person on student loans, has suggested that the percentage could vary with the amount borrowed, thereby producing an income contingent repayment that varies with both income and debt, yet only requires tracking a single variable: the amount of debt.

One argument against this approach is that borrowers do not routinely know what their tax liability is and that it will not be intuitively obvious to the borrower why tax liability should be used as the measure of ability to repay student loans. While both these assertions are true, it is just as easy to refer to the tax liability line of the tax form as any of the income measures. And while it may not be intuitive, it is a lot simpler to explain to borrowers that they owe a percentage of their tax liability than it will be to explain: take your adjusted gross income, subtract an allowance for basic expenses that varies for family size, and then apply the following rates that vary according to the amount you borrowed.

Another argument against using tax liability as the measure of student loan repayment is that there are certain deductions subtracted from adjusted gross income in the tax system that should not be exempted in determining student loan repayment obligations. While that is certainly true, a reasonable argument could be made that taxable income is probably a better measure of discretionary income than adjusted gross income with an allowance for basic expenses. Besides, as long as interest is charged on unpaid principal, the fact that borrowers' lower taxable income reduces their income-based student loan payment in one year means they will pay more later on, at no additional cost to the government (except in those cases where full repayment does not occur after 25 years). In my view, whatever additional "equity" is gained by not allowing these deductions to benefit the student loan borrower is not

worth the additional complexity entailed in establishing a wholly new "student loan repayment needs analysis".

Negative Amortization?

One of the thorniest issues entailed in designing an income contingent repayment system is that when a borrower's income-based payment does not even equal the interest owed on the loan, what happens to the unpaid interest. Is it added to the loan principal to be repaid in the future, a condition referred to as negative amortization, or is it forgiven by the government and added to the Federal costs of the program? This is a difficult question in part because borrowers are in such different circumstances at various points in the repayment cycle.

The best argument *against* negative amortization is the student who borrows for education and training that does not pan out and ends up chronically without sufficient income to repay his or her student loan. On its face, it does not make sense to add interest to principal for borrowers in this situation so that over time they owe several times more than what they initially borrowed.

The best argument *for* negative amortization is the medical school student who borrows $100,000 which far exceeds his or her income in the first several years after graduation when income lags behind debt service, but who will be more than able to repay once in an established practice. There would be much resentment if these borrowers had any or all of their obligations forgiven when their incomes were lower.

The difficulty is to design a repayment schedule that does not add to the burden of borrowers perpetually down on their luck, while not providing an unnecessary windfall for borrowers who eventually will be able to repay the interest they were unable to pay when their income was below their lifetime potential.

Forgiving a borrower's obligations after a period of time represents a partial answer to this dilemma. If the unpaid interest is eventually forgiven at the 25 year limit provided for in the 1993 legislation, then chronically underemployed borrowers will never have to come up with money that they do not have, while many of the eventual high income borrowers will repay their full obligations before the forgiveness period is reached.

The 25-year limitation on income contingent repayments included in the 1993 legislation is as charitable as the treatment in the United Kingdom, where forgiveness occurs after 25 years or when borrowers reach the age of 50. It is more charitable than in Sweden, where forgiveness of remaining obligations occurs only upon reaching age 65 or the death of the borrower.

But providing loan forgiveness after a certain period of time does not address the public relations and policy question of adding to the debt of many borrowers who clearly are in no position to repay and, as a result, adds fuel to the fire of critics who worry that income contingency is really a euphemism for lifetime servitude.

Single Schedule or Experimentation?

All of the discussions thus far on developing an income-contingent repayment schedule seem to assume that it is necessary to develop a single schedule of repayments that uniformly will be applied to all borrowers who participate in the program. This seems like a reasonable principle to follow given that the government needs to exhibit consistency in the application of its rules and regulations.

But the current determination to develop a single schedule of income-contingent repayment stemming from the 1993 legislation ignores one of the key lessons learned from the Income Contingent Loan (ICL) program that was created in the 1986 reauthorization of the Higher Education Act and was then terminated in the 1992 reauthorization. That lesson was: providing rigid rules that require all participating institution to follow the same procedures limited the ability of the Federal government to test the efficacy of various repayment schemes.

Because of this lack of flexibility in the ICL program, we now have no greater understanding of the impact of various repayment schedules than we did in 1986 before the ICL program was put in place. We are just as much in the dark in 1993 as we were in 1986 regarding how to construct an income contingent repayment schedule.

To learn more about the effects of income contingency from the 1993 legislation, which promises to be of much longer duration and of much greater magnitude than the 1986 ICL program, it may be worth considering introducing some experimentation into the repayment schedules that are now being developed. Since no effort is being made to provide for cross-subsidies between high and low income borrowers, it should be possible to develop a number of feasible and reasonable repayment schedules that borrowers could use depending on their circumstances, at no additional government cost.

For example, there could be a rapid repayment schedule for borrowers who wished to complete their repayments more quickly, and a longer schedule for borrowers who were in no hurry to pay off their loans. Based on the Australia experience, an attractive prepayment option with a discount might be offered, although this would increase the government's costs by reducing

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its "profits" from direct loans. In addition, perhaps one schedule could be developed in which the repayment amount would be based on a percentage of the borrower's income tax liability, with different percentages applied according to the amount borrowed.

The point here is that this variability would allow for evaluation of the effects of different repayment schedules, rather than picking one schedule now with very little understanding of what its potential impacts might be on the behavior of borrowers.

The principal argument against experimenting with different schedules will be that it greatly complicates the administration of the program. The IRS would have an apoplectic fit if it were forced to administer a half dozen or more repayment schedules, given that many in the agency do not want the job of administering income contingency in the first place.

But the fact that the IRS will not be servicing student loans for at least several years should add to the ability of the government to employ a variety of repayment schedules in the early years of the program. One assumes that it would be much more difficult to have this kind of flexibility if the IRS were the administering agency. This upon reflection may be the best argument of all for having state agencies rather than the IRS administer income contingency, allowing them to work from a number of models approved by the Federal government.

Income Contingency Only Through Direct Loans?

Throughout the student loan reform debates of the past several years, there has been much confusion about the difference between direct loans and income contingency. Direct loans involve how loans are financed; income contingency relates to how loans are repaid. Yet it has not been uncommon for generally knowledgeable policy-makers to begin a discussion on the merits of direct loans, and end with a review of income contingency.

This confusion, not surprisingly, has seeped into the recent legislation as well. For example, in the 1992 reauthorization of the Higher Education Act, an income-contingent component was tacked onto the Direct Loan Demonstration program, despite the fact that limiting income contingency to direct loans greatly elongated the time it would take to evaluate the income-contingent program.

Similarly, in implementing the 1993 legislation, many seem to think that income contingency should apply only to borrowers who participate in the direct loan programs, again extending the period of time before substantial evaluations of income contingency will be possible.

If the objective is to put in place income contingency as quickly as possible, it makes far more sense to allow students who have already borrowed through the guaranteed loan programs to participate in income contingency as well as those whose initial borrowing was in the direct loan program. This objective can be accomplished rather easily by allowing existing borrowers to consolidate their guaranteed loans into direct loans and then to participate in income contingency.

It does not make sense, however, to allow guaranteed student loan borrowers to participate in income contingency without first consolidating their loans. This would entail additional costs to the government, as the private loan holders would receive more subsidies or additional profits stemming from the longer term of repayment entailed in income contingency.

A Policy Driven Management Information System

Identifying information requirements for evaluating policy outcomes

Ray Haines

Management Has Both Policy and Control Objectives

The elected, appointed, and civil service officials who are charged with the management of direct lending as well as other student financial aid programs have responsibilities for the policy objectives of the programs as well as the proper control of the delivery systems. This paper will attempt to define the key differences between policy and control requirements and will make the case that the vast majority of traditional Management Information Systems (MIS) have been directed toward control, with little attention given to the identification or measurement of policy objectives. The distinction between policy and control is not entirely in what data are collected, but importantly in how it is used. Data that are currently collected on income level and location of applicants as well as information on the types of schools attended; such as four year, two year, and proprietary; can certainly be used to measure policy objectives related to the accessibility of higher education to students. Information such as race and gender, currently not collected, could also be used to address issues of equity and accessibility.

No analysis is made, nor opinion offered, on the appropriateness or adequacy of the MIS with respect to system controls. Rather, it will make the point that the management information systems supporting the direct lending system as currently conceived, pay little attention to either identification or evaluation of stated or unstated policy objectives. This paper will not definitively identify a comprehensive set of policy objectives, nor will it solve the problem of how to measure the few examples put forward. It will, however, offer a new paradigm for program managers - to change the perspective from which policy objectives are identified and measured from an internal view to an external view.

Policy objectives, for the purposes of this paper, are defined as those outcomes that reflect the social and economic impacts of the student financial aid programs. This definition is sufficiently broad to include the measurement of outcomes that may be unintended such as those discussed in the paper by Martin Kramer, Policy Implications of Direct Lending: Possible Unintended Consequences, '93. Intended or not - policy outcomes have to do with the effects of the direct lending program on society. Thus - **A policy driven Management Information System should be designed to measure the desired social and economic outcomes of the Direct Loan Program and, to the extent possible, should be able to identify and evaluate any unintended outcomes of the program.**

A policy driven MIS must be specified from the outside

If we visualize the Direct Loan Program as a black box process, with resources entering one side and outcomes exiting the other side, we could consider a few possible ways to measure the success of the program. We

could measure the inputs and outcomes or the ratios between inputs and outcomes. If we cared about speed, we could also measure the time required to produce the outcomes.

Assuming that we are measuring things we care about, and that the system is indeed producing what we expect, each of these would be **policy measures**, since they would be valid measures of the program's external objectives. Each is a fairly direct measure of the work of the system.

If, however, we measure the internal temperature of the box and the flow and redirection of material inside the box, or if we envision the possibility of hundreds of black boxes inside the main box each with more things to measure - the issues becomes less clear. Certainly each of these small details may have an impact on the functioning of the system in question, which then has an indirect impact on how our primary program performs. These are **control measures**. From a policy level, however, which of several control choices were made is not relevant, as long as the expected inputs produce the expected outcomes at the expected rate.

There are some critical assumptions in this hypothetical system.

- That we know what we expect as outcomes.
- That we know what inputs the system will require and in what amounts or numbers.
- That the things we measure are reasonably direct representations of things we care about.
- Conversely, that we are not measuring things that we don't care about. For example, if we don't care about the shape of the box itself, there is no reason to measure it.

A second analogy serves to illustrate the relationship and priority of importance between policy and control measures. Assume that a home owner has a thermostat on the wall (a control mechanism) set to 72 degrees. Now assume that on a pleasant spring day (60 degrees) the home owner decides to open all the doors and windows to let in fresh air. The primary policy objective has been changed from "maintain 72 degrees" to "let in fresh air." While these are not necessarily opposite policies, they are fundamentally different. The control mechanism, unaware of the policy change, will kick in and overcompensate to maintain the required 72 degrees. Left unchecked, at a minimum, substantial resources will be wasted. At worst, the system will overheat and destroy the home it was designed to manage, or itself.

In the case of student financial aid programs in general, and the direct lending programs in particular, the above analogies clearly break down if carried to extreme. The programs are not simple black boxes or even homes. Instead, they are very large and complex systems with government(s), institutions, contractors, students, parents, taxpayers, legislators, and regulators all playing a role.

The inputs and outcomes of this great system are not simple numbers, but are the education of our students and the attainment of our future, and involve billions of dollars of borrowed money. What is even more difficult is that no one knows exactly what the outcomes should be or how to recognize them, much less how to measure them.

These difficulties aside, however, it is clear that there are substantial differences between measuring control variables from inside the system and identifying and measuring policy objectives. It may be useful and even necessary, at some level, to know how many reams of duplicator paper are in the direct loan contractor's warehouse. The connection, however, between this information and the performance of the program in meeting policy objectives is distant at best.

By definition, the design of a policy driven management information system must be accomplished from a perspective outside of the system. That does not conclude that some of the measurements can not be made inside the system, or even by the system itself. It does, however, call for designers to take a broader view and consider the difficult issues related to measurement of outcomes uncluttered by the demands of system control requirements.

A continuum of needs

The Department of Education has discussed MIS needs at three levels and described top management, middle management, and operational staff reports that are primarily distinguished by their level of detail. The three levels provide a useful model for analysis, but I would like to suggest that the levels of reporting differ not only in the degree of detail but also in the type of information presented. Simply stated, the senior management requirements should be much more sharply focused toward policy measures while operational staff have first line responsibility for operational control, as illustrated below.

It is important to recognize that excellent system performance will only be achieved when all participants at all levels understand the major policy objectives and can be empowered to make decisions that further those objectives. That is, of course, precisely the objective of the "Government Performance and Results Act of 1993."

Identifying Policy Objectives

There are several reasons that policy objectives have consistently been inadequately addressed. The primary reason is that policy is very hard to identify and even harder to measure. Several contributing factors are

proposed to explain why basic policy objectives, even for far reaching programs that effect millions of Americans, are hard to identify.

Lack of Agreement

The political process that brings social programs into existence is one of compromise. Legislative action is motivated by multiple constituencies who disagree on the desired outcome. Lack of clear and unambiguous policy objectives is perhaps not only a result of the political system - but a requirement of it.

For example, it is generally accepted that a major program objective is to provide more equal educational opportunities to the poor. As pointed out by David Breneman, however, in his 1991 analysis of the GSL program, Guaranteed Student Loans: Great Success or Dismal Failure?, "...the motives for creating GSL had little to do with increasing educational opportunity or aiding the poor; instead, it was designed by the Treasury Department to head off legislation proposing a tuition tax credit. GSL was established as a loan of convenience to middle class families...its purpose being to save the Treasury money."

Clearly, political cover requires that the policy objectives be defined differently by a representative from a middle class district than one from a poor district. Recent efforts to reform government such as the Government Performance and Results Act of 1993 seek to provide "more objective information on achieving statutory objectives." Such reform efforts, however, do little to address the underlying problem of lack of clear statutory objectives in the first place. The student financial aid programs are not only massive - they have massive and diverse constituencies with widely differing priorities and objectives.

Lack of Precision

Lacking agreement, policy analysts are forced to resort to general statements of objectives which, by their lack of precision, are unlikely to offend any constituency. Outcomes such as access to postsecondary education, choice in the selection of an institution, and persistence in a program to completion of an education are accepted objectives. We will return to these objectives because they probably provide the best available short set of policy objectives for the program. It is easy to see, however, the problems that they create - or at least fail to solve. Access for whom? Access to what? How do we know if we have met equitable access as an objective if we do not collect and report data on race or gender? If money is not to be a criteria for choice - what replaces it? How are costs controlled if money is not an issue in the choice of education? Current debate with respect to issues of access, quality, equity, and cost control in health care can be instructive.

Measurements by Habit

Lacking clear perspective on what policy objectives are, we tend to fall into the habit of measuring what we have always measured. The Dow-Jones index and the rate of inflation, for example, are reported at least daily by virtually all major media and followed by millions, without clear evidence that either has any meaning in our daily lives. There is a strong tendency to identify and follow key indicators that we have always used - forgetting to associate them with the real objectives. Most common among these measures of habit are number of loans, dollar value of loans, and default rates. An airline pilot who limits his or her interest to air speed and altitude without consulting a compass or other measure of direction is clearly focusing on too narrow a set of indicators.

Measuring on-line response time, or number of letters printed, or even how many loans are made per year may provide proof of activity - but what do these things tell us about the direction or effectiveness of the program?

Goodness - Overrated?

Some indicators are so obviously good that they are unchallenged and tend to become primary goals at the expense of real policy objectives. No one would deny that there should be no fraud in the system, or that no one should profit excessively, or that the system should not be manipulated for political gain, or that students should repay their loans, or that all participants should perform their assigned role precisely. It is also certain that cost saving is a goal that is easily accepted, especially if it is immediate short term savings.

Yet, none of these very good and indisputable objectives provide the program with a single reason for being. Ironically, all of these good objectives could be accomplished by cancelling the student financial aid programs altogether.

The Time Impact

An additional, but significant complication, is the relatively long life cycle of large student financial aid programs. Even if society's objectives were well defined and well understood, society continues to change over time. It could be argued that society changes it's collective mind faster than it's real needs, but the distinction is not relevant.

Over the past twenty years we have seen and are continuing to see different understandings with respect to the following questions: How much education? For whom? What kind? For how long? At what age? How much retraining? What is the value of liberal arts vs technical education?

At the same time, there is a continuing explosion in the rate of knowledge and technology growth as well social and political change. The cold war that

sparked the National Defense Student Loan has given way to issues of jobs, economic growth, and international competitiveness.

In parallel with these issues are periodic shifts in opinion and expectations about what the various governments' role should be with respect to education. In addition, the probable discovery of any unanticipated outcomes will create new needs for policy identification. **Clearly, whatever policy is - it is not static.**

An Example List:

The following list of policy objectives is proposed for purposes of example. While they are believed to be reasonable, it is beyond the scope of this modest paper to produce a definitive list of policy objectives for student financial aid programs.

- **Access** to post secondary education by any American student who is otherwise qualified with respect to educational preparedness, motivation, and willingness to repay; without regard to race, gender, or income level.
- **Choice** in the selection of an institution without regard to race, gender, or income level, so long as the student recognizes that funds are loaned and that the cost of educational choices must be eventually paid.
- Ability of a student, once started on an educational program, to **persist** to the completion of that program without being forced to drop out for financial reasons.
- The degree to which society experiences **productivity improvement** as a result of debt financed education.
- The degree to which former **students repay** their loans.
- The degree to which former **students are satisfied** with their choice to borrow money to obtain an education. Ultimately, was the value of their education perceived to be greater than the debt incurred?

There are also several specific objectives for the Federal Direct Student Loan Program to measure its effectiveness in comparison to the Guaranteed Student Loan program. While these do not directly measure primary outcomes of the program, they received specific attention in the current procurements and are therefore proposed as policy objectives.

- Lower capital costs than the guaranteed loan programs.
- Improved Customer Information (presumably a contributor to student satisfaction, listed above)
- Flexible Loan Repayment Options (presumably a contributor to students repaying of their loans and reduction in the rate of their default)

Challenges with Measuring Policy Results

It is clear that even if everyone agreed on the above list, or some other list, as an authoritative set of objectives, there would still be significant challenges in measurement.

MUCH NECESSARY INFORMATION MUST COME FROM OUTSIDE THE PROGRAM

The attempt to improve on the GSL program by means of the direct loan program, taken by itself, could be compared to fine tuning a car's engine to improve both speed and gas mileage. Those are highly desirable objectives, but without a specific destination and a road map, such tuning of the system's internal performance contributes little to reaching a destination.

If we reduce the cost of student borrowing by the Direct Loan Program without an external examination of our destination (i.e. Policy Objectives) then we have improved the system but done nothing to reach our objective or destination. The system can measure how many loans were made in a given month, but it is more difficult to measure client satisfaction with the result of their decision to borrow. It is relatively easy to measure the default rate, but much more difficult to measure the social and economic impact of a defaulting student. It is easy to measure the value of loans made per year, but it is much more difficult to measure the increased productivity of a citizen as a result postsecondary education.

Non-traditional means of data gathering and analysis will clearly be a requirement of a policy driven MIS. The outcomes of financial aid programs are spread over all elements of society and over time; they are economic and social; some outcomes can be measured with precision and others will be opinion and perception. A policy driven MIS will include numerous, independent, well designed longitudinal studies, surveys, focus groups, and other tools commonly used by marketing professionals and social scientists. The MIS will also require the most creative analytical skill available and a constant and vigilant effort in order to retain its external perspective and modify the outcome measures to meet changing policy objectives.

THE CONTRACTING PROCESS SHOULD ALSO BE POLICY DRIVEN

A policy driven MIS will be of little value, if contracts between program participants are not also policy driven. It is clear from past practice that, by the time the ink is dry on a typical Federal contract (or Federal employee's job description for that matter,) any hint of a relationship between policy objectives and performance measurements is obscure at best. As illustrated in the case of the runaway thermostat described earlier, policy objectives can

not be achieved, or will incur substantial waste, if the major vehicles for administering the program are control driven rather than policy driven.

Once policy objectives are defined and understood, contracts should be rewritten that reward the achievement of objectives rather than the traditional units of measure, either paper or electronic.

LARGE AND COMPLEX PROGRAMS TEND TO REPLACE (OR BECOME) THE POLICY

One of the most insidious characteristics of big programs is their tendency to become policy. A program, originally designed to carry out policy, gradually becomes the paradigm from which all future understanding is derived. The policy is believed to be successful if the program continues to exist, and a failure if the program is discontinued. All decisions about what can, can't, or should be done are based on the program's view of the world, with little regard for outside influences.

Interim Steps

Challenges aside, there are interim steps that can be taken by creative, dedicated, and empowered middle management and operational staff. Much data are available from within and outside the system about the students who receive financial aid, about where they attend school, and about their repayment patterns. Existing data are enough to start to develop and test hypothesis about policy outcomes. Such efforts need not wait for official policy direction.

Several specific high level actions can be recommended.

Recommendations

Primary Recommendation:

Identify and publish actual and probable policy objectives

The list of objectives provided with this paper can be a starting point, but the process must continue. A formal process of gathering input from key constituencies should be undertaken and reviewed annually. This should include survey's of Congress, states, schools, students, and taxpayers at large. The objectives should be grouped, unambiguously stated, and prioritized based on the input received. The list should also include a category of potential but unintended consequences of the program to be avoided. The Secretary should publish these policy objectives which will in turn provide a benchmark for measurement of program performance.

Such an annual review and update process should be geared to identifying and modifying outcome measures to meet changing policy objectives. Such a process would be entirely in keeping with the objectives of the Government Performance and Results Act of 1993, and would provide the Secretary with a sound basis of support for published objectives.

Four Supporting Recommendations:

1) Establish a council of external policy advisors

It is inherently difficult for any person within a system to gain and maintain an external perspective. A council of external policy advisers should be developed to help draft and continually review the concise policy statements. The council would gather formal input from congress, and also provide a broad network of perspectives from educators, students, private industry, state and local governments, and citizens at large. The objective would not be to compete with statutory objectives, but to complement and add precision to them.

This council should consist of a mixture of formal and informal, semi-permanent and ad-hoc components. Together, the council should provide ongoing input on evolutionary policy objectives; provide suggestions on sources of MIS data, and provide analytical perspective and assistance.

2) Identify and use non-traditional sources of information

Equipped with a list of objectives, begin to identify non-traditional sources of information which may provide insight into the measurement problem. Take a lead from social scientists, marketing professionals, polling organizations, and members of the media who are comfortable with survey instruments, focus groups and the like. Be prepared to use sources of data that are not funded by the department as well as many that will be.

Involve economists and labor experts to explore measures of productivity change, earning power, employee satisfaction and other ultimate measures of the success of an education program. Use the network of policy advisors for input on sources of information. Seek out and recognize a mixture of quantitative and qualitative data collection and research methods. Particular attention should be given to the need for long term longitudinal studies which will be slow to produce definitive results.

3) Perform non-traditional analysis

The challenges for the policy driven MIS are orders of magnitude more difficult than a management control system. Enough so, that the fact that policy measurement has not been emphasized, now becomes clearly understandable. The objectives will be changing, the data will come from a

variety of sometimes inconsistent sources, and the time between cause and effect will be extraordinary. In addition, competing constituencies will continue to do their own analysis on the results.

4) Revisit the design and contracting process

Having published a list of objectives - revisit the design of the program, its supporting systems, and the contracting process. Every significant component should be measured to determine what policy objective(s) it supports. A part of determining these relationships should be at least some speculation about how to measure the impact of the specific component on policy objectives. Clearly, it will not be possible to compensate a contractor based on results that must be measured through a twenty-year longitudinal study. It should be possible, however, to speculate on what actions today will produce desired results and be sure that performance measurement is at least based on something that we think will produce the desired outcome.

Conclusion

Clearly the primary recommendation, to identify and publish policy objectives, is the most important and the most difficult. The problem will not have been solved, however, by the completion of step one. It will only then be completely identified.

The stakes for the educational finance programs, especially the direct lending program, are so high that the effort must be undertaken with courage and determination. The public has a right to expect effective and efficient educational financing. The financing programs, however, must enjoy the trust of that same public to be successful. To the extent that the important policy objectives are clearly identified and form the basis for program evaluation, the public's attention will be focused on results. To the extent that policy objectives are not identified, public attention will be distracted from important long term issues in favor of the interest group issue of the moment.

Ultimately, the Direct Lending Program will be evaluated on how well it serves in meeting the social and economic needs of our nation rather than short term savings and efficiencies. It then seems important and appropriate that we identify and reinforce the destinations we are trying to reach. Let us make sure that we are not tuning the engine and increasing its speed, only to find ourselves far from our intended destination.

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Direct Lending and Consumer Information

Sandy Baum

Neither a borrower, nor a lender be;
For loan oft loses both itself and friend...
(Shakespeare, *Hamlet*, Act I, Sc. 3, Line 75)

As direct government lending replaces private capital in the student loan market, the Department of Education will become responsible for providing borrowers with the information they now get from the variety of institutions involved in the student loan process. Ideally, excellent consumer information could help to mitigate the problem noted by Shakespeare.

Currently, financial aid directors can choose from among the publications of major banks, guarantee agencies, secondary markets, and state and Federal governments, or can design their own materials to provide their students with information about borrowing and repaying. Under a direct lending system, the Federal government should provide not only the technical information required by law of all lenders, but also standard materials designed to meet the unique needs of student borrowers.

The first step in designing the consumer information system should be examination of the existing information system and its adequacy. Many discussions of student loan default seem to incorporate the vague notion that too many students don't understand that they are borrowing rather than receiving a grant and that if only we had better information for them, many fewer would default. There is, however little or no concrete evidence to support such an idea. Studies of default consistently suggest that it is individual characteristics of borrowers, rather than the practices of the institutions they attend, which influence default. (See, for example, Wilms, Moore and Bolus (1987) and Knapp and Seaks, 1992). Accordingly, it cannot be assumed either that current information provided to students is inadequate or that better information will reduce the default rate.

There is, however, considerable confusion among borrowers about how to apply for deferments, to whom to send their checks, and other details of the repayment process. And the widespread problems in this country relating to personal financial management, appropriate levels of borrowing, and timely debt repayment, not just with respect to education loans, indicate that there is considerable room for educating borrowers about their rights and responsibilities. Hopefully, a more coordinated system of consumer information will catch many borrowers who now fall through the cracks because of the practices of their institutions and improve the relationship between student borrowers and their new lender, the Federal government.

Although adequate consumer information is obviously vital, the costs and benefits of elaborate efforts designed to assure that all students understand exactly what they are getting into must be weighed. The reality is that the vast majority of borrowers are quite clear about the lending process and have no difficulty paying back their loans. Spending a lot of money on innovative

communication methods is probably not worthwhile. Efforts should be focused on students at those institutions where there seem to be problems, but it must be recognized that regardless of the information they receive, there will always be students who default, either because they are not motivated to repay, because they drop out of school and feel they should not have to pay, or because of financial constraints. No amount of information will make this problem disappear.

Several basic principles should be kept in mind in designing a consumer information program for direct lending:

1. Information should be as simple as possible.
2. Publications should be brief.
3. Small doses of information should be provided frequently, rather than large amounts of information at one or two critical points in the process.
4. The attitude conveyed in the materials should be friendly and supportive, not accusatory.
5. Answers to questions should be easily available.

These five principles underlie all of the following discussion, which begins with a breakdown of the types of information which should be provided at various stages of the loan process. It is very difficult for people to absorb large amounts of information on a variety of topics at one time, even in the unlikely event that they read all of it. Therefore, it is important that the Department's consumer information program be designed to provide brief explanations of specific topics in separate documents. These documents can be made available to borrowers periodically from the time they are in high school to the time they complete repayment. (The one page series of documents published by College Credit on subjects such as Tax Tips for Students for 1992, Making the Most of Your Money, and When Your Student Loan is Sold provide one example of this type of approach.)

These new publications could be an important supplement to the Department's existing Student Guide.

General Information About Borrowing

Considerable effort should be put into educating high school students and their parents about borrowing for postsecondary education. This effort has to include general background information on credit markets and on decisions about how much and under what circumstances to borrow. Writers on the broad subject of consumer credit consistently bemoan the ignorance of the public. One wrote, "During my ten years in banking and finance no more than 2 percent of the ten thousand loan applicants whom I interviewed understood the facts about credit... The reason that those people did not understand credit is obvious: we don't like borrowing money" (Gibbs, p.x).

Student aid directors at selective colleges and universities may not face this problem, but those at community colleges and proprietary schools certainly do. Their students are not familiar with credit markets at all and need more information than just a brochure accompanying their loan applications. For some groups, cultural attitudes create a barrier to borrowing. These attitudes must be understood and addressed over an extended period of time.

Many people are both reluctant to borrow because they have heard that going into debt is bad, and ambivalent about continuing their educations because most people around them have managed without college. So it is important that the information include encouragement about the value of investing in higher education and about why it may make sense to borrow for school even though it doesn't make sense to borrow for many other purposes. In other words, students should be educated and warned about borrowing, without being discouraged.

Balance must be struck between communicating the seriousness of undertaking loan obligations and communicating the value and reasonableness of borrowing for education. Too many warnings and too much focus on the evils of default may discourage those who stand to benefit the most. A negative side-effect of the widespread focus on high-risk students, especially those at proprietary schools, defaulting, is that there may be a tendency to discourage these young people from borrowing. Attending the wrong school is one problem. Borrowing for the right school is another issue altogether.

All high school students should be exposed to this background information about borrowing, including the concepts of principal and interest, the importance of regular and timely payments, and the repercussions of bad credit ratings. Still, many older students will arrive at institutions without this knowledge. Therefore, simple materials with very basic background about the meaning of borrowing should also be available at educational institutions.

Entering Students

Students will not tune in to the details of the student loan program until the moment when they need the money. Literature which accompanies loan applications and approval notices will have to provide this information.

One problem the Department faces is the extent to which information materials and procedures should be regulated and standardized. It seems clear that ensuring that all borrowers and potential borrowers receive certain basic materials published by the Department is advisable. Any borrower can also benefit from an entrance interview. However, the varying needs of different student populations must be taken into consideration.

Aid officers at selective colleges do not spend much energy on consumer information issues. They do not, in general, believe that their students have

any trouble understanding exactly what their rights and obligations are with respect to their student loans. Requiring them to devote extra resources to more detailed or more frequent information would probably not be constructive.

On the other hand, there are large groups of students for whom the printed information must be on a very simple level and who need multiple reminders. The best approach would be to make the written information appropriate for this group of students. There is no problem with the information being too simple for others. A few students may choose to read the detailed legal disclosures accompanying their loans. But what most need is a brief and simple explanation of the basic facts about their loans: how much they have borrowed, what the interest rate is, when they will be expected to begin repayment, what some sample repayment schedules might look like, how and under what circumstances they can apply for deferment or forbearance, and an 800 Hotline number to call for any information they might need.

Another important consideration is that information should be designed to improve the relationship between borrower and lender. Some studies have suggested that creditor fraud or deception in general consumer credit markets is prevalent enough to color people's views about lenders. (See, e.g. Caplovitz, 1974.) Many students may be coming in with the preconceived notion that anyone lending them money is trying to cheat them in some way. The tone of the materials provided by the Department should be carefully designed to counter this impression.

Students should be clearly aware that the government is providing them with a subsidized loan. They should know that they are paying back much less than they would if they borrowed on the open market. They should also understand that the government wants to accommodate them, and that there are a number of options available to ease the repayment process. Efforts in this direction will help to increase borrower willingness to pay. The details of repayment possibilities, however, should not be discussed at this point.

Information During School

Borrowers should not be forgotten between the time they take out their first loan and the time they leave school. The loan counseling process must be just that - a process, not a single event. This is the only way that all borrowers will fully understand their rights and obligations. (See Coles et al for discussion of this idea.) Those who borrow again should be given materials which review the basic conditions of the loans. Discussion of how much borrowing is reasonable and samples showing how total debt and monthly payment levels will be affected should be provided. Any time a payment is made to the student's account with the institution through loan proceeds, the student should receive a statement which indicates clearly that he or she has received a loan and that the total education debt has increased to a new level.

Loan disbursements which go directly to students to cover living expenses, rather than into institutional accounts, deserve some special attention. One danger is, of course, that the proceeds will be spent too quickly, and will then not cover expenses for the specified period of time. Another problem is that students are more likely to see this money as "theirs" and less likely to be totally aware that these are loans specifically for the purpose of covering the costs of their educations. A special notice should be designed to accompany these loan payments, to try to overcome these difficulties.

Those who do not borrow again should also continue to receive information during the period between the time they take out their loans and the time they go into repayment. They should be reminded what their debt level is, when they will have to begin repaying it, and what options will be available to them.

Exit Information

Personal interviews with departing students may have the potential to be more important than any other form of communication in influencing the students' understanding of and commitment to repayment. However, this approach is not a particularly practical one. Students graduating from 4-year schools should certainly have an exit interview. But the benefit to this group, the vast majority of whom are quite clear about their obligations and can process clearly written material successfully, will be limited. Certainly the cost of individual or small group interviews at large schools could be prohibitive.

Those who most need the personal interviews are least likely to get them, because many of them tend to drift in and out of school and not to inform the aid office when they plan to leave. Some community college aid officers find that one-to-one conversations are their best tools of communication, but that it is frequently not possible to catch the students who would benefit most.

Accordingly, while the concept of exit interviews should certainly remain in place and efforts for oral communication of student debt rights and obligations should continue, the written materials distributed to all borrowers must be adequate even in the absence of such interviews.

The information provided to student borrowers who are leaving school will have to be totally redesigned because of the implementation of a set of alternative repayment plans. The obvious danger is that a situation which already seems complicated to many borrowers will become totally inscrutable.

One tradeoff will be between brevity and examples. On the one hand, students are not likely to read either long publications or multiple publications they receive simultaneously. On the other hand, examples of typical borrowers and the effect different repayment plan choices would have on them will be an important part of explaining the new system. One of the problems the Department will face in designing this literature is how to clarify the pros and cons of some of the new options without contradicting the Administration's

"advertisements" for the policies. Income-contingent repayment and national service have been billed as solutions to many of the problems of student borrowers. Some aid officers have already observed students shrugging their shoulders at debt and believing it will be no problem to just pay it off through National Service. National Service should be listed as one option, but the limited number of students involved and the restrictive conditions should be stressed.

Similarly, because of the political nature of the support for income-contingent repayment, students who would not be best off with this option may be inclined to choose it. Examples of income-contingent repayment schedules for a variety of earners with large and small debts should be provided. The length of the repayment period and the total amount paid should be clearly stated. There should be descriptions of the types of people who would be most likely to benefit from each repayment option.

If income-contingent loans are repaid through employer withholding, which seems like the only feasible method, there will have to be very clear information which will make people comfortable about giving their employers information on their debts. (Obviously, a related problem will be making employers feel comfortable with this new bureaucratic burden.) It would be most unfortunate if the low-paid workers for whom ICL's are most appealing hesitate to participate in the program for fear that they will be opening their private affairs to the scrutiny of their employers, or if employers hesitate to hire people with student loans because of the added paperwork required.

Again, these descriptions should be very simple, but realistic. Many students will surely find themselves unable to choose. They should be given an 800 Hotline number they can call for advice. There clearly has to be a default option for those who do not make a choice. Hopefully, this will be the standard repayment plan.

Because of the difficulty of getting people to read and comprehend large amounts of material at one time, the information required for borrowers to choose a repayment plan should be sent out together with only a minimal amount of additional information, letting the students know when they will have to begin repaying and how to go about applying for a deferment. The same form which allows a check-off for repayment plans might have a separate box to check if the borrower wishes to apply for a deferment, specifying which reason applies. The appropriate form could then be sent without the student making an additional request. This is an area where considerable confusion apparently exists now, so the current process and materials should certainly be reviewed.

Once the student has made the repayment choice, material on modifying the repayment plan and on default should be sent. Borrowers should be given examples of what can happen to people if they default. But they should also receive a clear explanation of how the Department will assist them if they are

having difficulty meeting their payment schedules. Reports of student aid officers who deal with defaulters are consistent with studies of other consumer lending and bankruptcy cases. Apparently, a high percentage of those who stop repaying their debts could and would repay if they could easily arrange a new schedule. Partial payments and irregular payments are clearly better than no payments. One study of personal bankruptcy showed that about half of the individuals involved could have paid their creditors in full without undue hardship if they had been given additional time and some specialized attention (Chapman, p.25). The implication of this finding is that borrowers need to be clearly informed when they begin repayment that there are alternatives to default if they run into problems. It might be advisable to send some information periodically to borrowers in repayment. This could include simple information on how to change repayment plans if desired and under what circumstances this might be a good idea. It could also contain reminders about the repercussions of default and about the 800 Hotline number to call for additional information. On the one hand, the majority of repayers don't need these reminders. On the other hand, the additional complication of alternative repayment plans will mean that more people will be confused. The cost of sending out such a reminder with new coupon books (if coupon books are used) would probably be worth the benefit.

Specific Population Groups

Different groups of borrowers have different needs. It would be a waste of resources to spend the time and energy required to provide the necessary information to single mothers on welfare or to high school drop-outs enrolling in trade school to every undergraduate borrower at elite private colleges. A balance has to be found which does not assume knowledge or understanding on anyone's part, but which communicates appropriately with each group.

Older students, single mothers, students in short programs, and other groups might be targeted for special information programs. Adult borrowers face problems which differ considerably from those of the typical 18-22 year old college student. The fact that they already have household financial responsibilities may make it more difficult for them to repay loans. We would like to believe that many of them will also be saving for their children's educations at the same time that they are repaying their own loans. The Department should design some materials particularly for this group, providing appropriate advice about making the decision to borrow and about budgeting. (The Loan Counseling Committee of American Student Assistance publication, Financing Your Education As An Adult Learner, is a good example of this type of literature. It is well-written and contains the appropriate information, although it is long and the same information should be contained in several shorter publications as well.)

Single mothers are a particularly vulnerable subset of the adult student population. In addition to family responsibilities, they are likely to have lower earnings than other postsecondary graduates. In this area, it will be

particularly important to provide sound advice without discouraging people from continuing their educations. Some of the focus should be on alternative sources of funding which might help people to limit the necessary amount of borrowing.

Although it may be difficult to deal with this politically sensitive issue, it would also make sense to design some materials specifically for students in programs which have historically led to loan repayment problems. The idea would have to be guidelines for students planning to enter certain types of occupations. The examples used in these materials could focus on realistic earnings patterns in these occupations and on how loan payments would fit into a typical budget. Again, the idea is not to discourage borrowing per se, but it is to warn students against starting down a path which has led so many others into difficulties.

Designing Materials

For a significant segment of the student loan market, current consumer information is perfectly adequate. Banks, guarantee agencies and institutions, in addition to the Department of Education, have put considerable effort into producing literature which will make the conditions and requirements of the Stafford Loan program clear. The Department should certainly not start from scratch in composing its literature. It should collect the literature currently in circulation, test some of it on focus groups, and take the best of what is out there as a starting point. The "Student Guide" gets high marks from many aid officers. Certainly, the expertise in the Department's Training and Program Information Division should be fully taken advantage of by the Direct Loan Program. The Department should examine the publications of banks (particularly CitiBank, which is frequently mentioned in the aid community as having done the best job with consumer information), guarantee agencies, secondary markets, College Credit, Educational Opportunity Centers, and other lenders. In addition to evaluating the literature in-house, it would be advisable to test it on some focus groups.

With an understanding of the strengths and weaknesses of the existing literature and with a clear set of goals, the Department should convene a representative group of financial aid officers to assist in designing the literature and the other aspects of the consumer information program to accompany direct lending. These are the people who see the effect the information has on the students, who field the day-to-day questions, and who do most of the explaining. Their input, and particularly the input of those who work with at-risk students, will be invaluable.

In general, the materials should be as simple and straightforward as possible. They should be designed with the lowest common denominator in mind and tested on people who know nothing about student loan programs.

Other Methods of Communication

Written materials should be supplemented by videos, which can be shown to high school students and on college campuses. The Department should also consider using the mass media to reinforce some of the information about the new student loan program. In addition to designing effective materials, providing guidelines for required entrance and exit interviews, and ensuring that there is an adequate 800 Hotline, the Department should be engaged in conversations with aid officers.

Workshops on default prevention, on the ins-and-outs of various repayment options, and on effective financial management could be useful in several ways. In addition to conveying information which might make aid offices more effective in counseling students, such workshops could strengthen the relationship between the Department and the aid officers. The number of aid officers who have the resources to participate in national meetings and workshops is generally small relative to the total number in the profession. It is quite likely that many of those who are not well-connected within the profession are also those who are most in need of assistance, who feel least a part of "the system," and who have anxiety about managing the direct lending system. Anything the Department can do to help these people, whose students are probably more likely to default than others, to feel both responsible and powerful in terms of their student borrowers would be positive. This type of program would also provide constant feedback to the Department on the functioning of the direct lending program and on the consumer information being provided.

Implementation

DOE should strike a balance between overseeing and coordinating these efforts and facilitating the dissemination of effective materials, and between setting detailed requirements for precise procedures to be carried out on each campus. Burdening aid officers with information regulations which may not be appropriate for every student body should not be part of the innovation of Direct Lending.

The Department will provide materials and guidelines to aid offices, but there will still be considerable concern over any additional costs which might be incurred on campuses as the banks fade out of the student loan picture. Currently, some aid officers tell students to go to the lender if they need more information. (Some banks also tell students to go to their aid officers if they need more information.) With the entire burden now at the institutions, some schools may have to hire additional staff to provide adequate counseling. The Department's aim should be to provide materials and guidelines which prevent this need. Otherwise, unless considerable subsidies are forthcoming, many aid offices will simply be unable to comply in any but the most minimal way with the Department's efforts to improve consumer information.

Evaluation

Evaluating the adequacy of the consumer information provided is not a straightforward task. The materials distributed can be easily evaluated for effectiveness, but the consistency with which institutions follow through on the prescribed process and the actual effectiveness of that process are harder to monitor. As discussed above, the default rate may not be a good indicator. Perfect communication with borrowers will not eliminate default and borrowers who are unclear about all the details still know, by and large, that they have loans and that when they get bills they are supposed to pay them.

The written and audio-visual materials should be evaluated carefully during the time they are being designed. This process should involve both financial aid directors and potential borrowers. The Department should set up focus groups with high school students and with first year students at a variety of institutions to test the literature. In addition to collecting general reactions, there should be pre-tests and post-tests to find out how much information is actually conveyed by the materials.

Focus groups should also occur with borrowers at later stages - those who have been in school for a while, those who are finishing, those who are just beginning repayment, those who are completing repayment, and those who default. Because the problems with communication at selective colleges and universities are minimal, these focus groups should concentrate on students from institutions with high default rates and other institutions whose student bodies are more likely to be unfamiliar with credit markets and to have difficulty with complex information. Questionnaires sent to these groups might also work. Any evaluation process should be designed by people with significant experience in this area.

Examining the repayment option choices made by various categories of borrowers would be useful. Enough information should be collected to allow analysis of the extent to which borrowers are choosing the options which are likely to be best for them.

Another part of the evaluation could focus on the use of the 800 Hotline. The number of calls received and the subjects of the calls should be monitored. It should be possible to keep track of what types of borrowers call with questions about their own loans (as opposed to general questions, for which they would not have to identify themselves). On the one hand, effective written materials and adequate entrance and exit interviews at institutions should lead to lower numbers of calls. On the other hand, adequate dissemination of the 800 Hotline number and satisfactory responses to those who call should increase the number of calls received. So the evaluation will have to be more than a simple count of calls. A thorough examination of the types of calls received should, however, provide insight into the areas in which the written information may be inadequate and the groups of students who need further attention.

Despite the caveats noted above about its significance in evaluating consumer information, the default rate should be monitored and it would make sense to sample a few institutions with high default rates and monitor their consumer information process for a couple of years, providing carefully selected literature and making sure that adequate entrance and exit interviews are conduced. Any changes in the default rates should be noted.

Conclusion

The main points to be kept in mind in designing a consumer information program for Direct Lending are:

--the basic principles of simplicity, brevity, frequency of contact, supportive attitude and accessibility of answers to questions;

--evaluating and making constructive use of existing materials providing information about student loans;

--including aid officers in the design and evaluation of the consumer information program; and

--providing standard materials and guidelines for dissemination without imposing detailed requirements which involve unnecessary costs for many institutions.

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The Federal Direct Student Loan Program

New Era or Old Error?

Elizabeth Bauer Hicks

The credit belongs to the man who is actually
in the arena, whose face is marred by dust and sweat and blood,
who knows the great enthusiasms, the great devotions, and
spends himself in a worthy cause, who at best, if he wins,
knows the thrills of high achievement, and if he fails, at least
fails daring greatly, so that his place shall never be with those
cold and timid souls who know neither victory nor defeat.

- Theodore Roosevelt

Introduction

On August 10, 1993 President Clinton signed the Student Loan Reform Act authorizing the Federal Direct Student Loan Program (Direct Loans), thus ending the controversial debate over whether to begin replacing a guaranteed student loan program with a direct loan program. Yet the debate on whether direct lending will be the panacea for the problems that caused Congress to seek a radical restructuring of the Federal Family Education Loan Program (FFELP) is far from over.

One of the recurring themes in the debate between proponents and opponents of direct lending is the degree of institutional administrative burden. The very fact that the term "burden" is used -- rather than other terminology, such as "functions" or "responsibilities" prejudices the argument in favor of the view that direct lending increases a school's workload.

Among members of the higher education community there is a wide variety of concerns, opinions, and perspectives on this issue. Some recent studies indicate that a direct loan program decreases the administrative functions of all schools, regardless of their size or degree of automation (Jacks and Hicks, 1991). Other studies state that the tasks schools will perform under direct lending are relatively uncertain at this time (Russo and McAnuff, 1991).

Some members of the higher education community envision the direct loan program working like a combination of the Federal Pell Grant and Federal Perkins Loan program (Butts and Hicks, 1992). They point out that direct lending builds on the infrastructure for other Federal financial aid programs, thus reducing institutional workload and costs (Jacks and Sullivan, 1993). They further indicate that once one understands that the Federal government -- not the school -- is the lender, the myth of increased institutional workload is easily dispelled (Hicks, 1993).

Other members of the higher education community state that the actual program regulations will greatly impact institutional workload and costs (Flink, 1992). New computer systems, new staff training, and increased staff time are frequently named as elements of increased administrative burden (The Education Resources Institute, 1992). In this view, none of the current workload would diminish, rather schools would assume lender and guarantor responsibilities with little, if any, compensation (National Council of Higher Education Loan Programs, Inc. and Consumer Bankers Association, 1991).

Finally, there are others who find direct lending appealing for a number of reasons -- including administrative streamlining -- but recommend improving the current FFELP system, rather than radically restructuring it (Rutter, 1992).

In part, the difficulty in coming to an agreement concerning the indicators and measures of administrative burden is based on:

(1) Lack of agreement on the role schools currently play in the guaranteed loan system.
(2) Failure to understand direct lending.
(3) The fact that there are substantially different institutional workloads under the current guarantee system.
(4) Inadequate information on the range of management options available to institutions under direct lending.
(5) The probability that direct lending decreases the workload of the financial aid office, but increases the workload of the business office.

This paper is not a policy paper, rather it is a paper addressing some of the questions that need to be answered with respect to the role educational institutions will assume in the Federal direct student loan program:

(1) What are the practical issues institutions will face in the implementation of direct lending?
(2) What strategic planning is necessary in order for educational institutions to prepare for direct lending?
(3) What performance indicators can be used for assessing the role and impact of institutions in direct lending?

The scope of the paper is confined to a discussion of the impact of institutional administrative burden on the institutions alone, and not the impact the administration of direct lending will have on the students an institution serves. The issue of the quality of service for students at direct lending institutions is an important topic for future research.

The paper is divided into four sections: an overview of direct lending; a descriptive analysis of the functions institutions perform under direct lending, which comprises the body of the text; a strategic planning approach for institutions preparing to enter direct lending; and a brief exploration of possible performance indicators for measuring the role and impact of institutions in direct lending.

The audience for the paper is broad including: the Department of Education and its contractors for direct lending; educational institutions planning to participate in direct lending; and parties interested in learning more about how direct lending will work on the campus level.

The paper argues that the success or failure of direct lending -- whether one supports direct lending or not -- depends to a large degree on whether the players involved seize the opportunity to make this program the beginning of a new period in the administration of Federal student financial aid. If past problems with the delivery of aid are not properly identified and corrected, the restructuring of our largest Federal student financial aid program will be futile.

In short, we are embarking on either a new era or an old error. The decision is ours.

Overview: Understanding Direct Lending

Whatever varying opinions exist on the issue of institutional workload under direct lending, clarity was brought to this matter in an April 1993 Dear Colleague letter in which Secretary Richard Riley disclosed the Department's plans for developing direct lending. The letter states that it is "simply not true" that it will be complicated and expensive for schools to participate in direct lending. The burden on most institutions will be "radically reduced" because of the centralized administrative structure under a direct loan program, as opposed to the decentralized nature of a guaranteed loan program.

The letter goes on to provide some empirical data to support Secretary Riley's claims. In particular, the letter details the new activity schools will perform under direct lending -- originating loans. No school will be required to originate loans. Those that choose to originate will perform two new functions: collecting and transferring properly endorsed promissory notes to the servicer; and reconciling the account. The Department will provide software to accomplish these new tasks. The software and accompanying training will be available to schools free of charge.

The Secretary issued further information concerning institutional functions, workload, and costs. Most schools already have the technology and experience needed to participate in direct lending, even as loan originators. If an institution originates loans in the Federal Perkins Loan program, it has the capacity to do so under Direct Loans.

Most importantly, institutions will not service or collect loans. The Federal government, as the lender, will contract with a number of organizations to perform servicing and collection of direct loans.

To ensure that institutions do not face any additional costs, the Department recommended a small administrative fee to cover the costs of origination. For schools that cannot, or do not wish to, originate loans, the Department will pay an alternate originator to perform this task.

In her May, 1993 testimony before the Senate Labor and Human Resources Committee, Deputy Secretary Madeleine Kunin indicated the Department does not foresee increased administrative workload or costs to institutions and carefully drafted the Student Loan Reform legislation to meet that intent.

The Federal Direct Student Loan Program replaces the Federal Direct Loan Demonstration Program authorized in July 1992. The final regulations for the direct loan demonstration program, issued in July 1993, broadly outline the responsibilities institutions will perform, thereby providing institutions with a great deal of autonomy in the micromanagement of direct lending. In short,

the outcomes are specified, but the means by which those outcomes are achieved is left to institutional discretion.

The September 1993 school participation notice states that the program called for in the Student Loan Reform Act of 1993 probably will be based on the final demonstration program regulations. Given this probability, the author assumes that direct lending will operate as a hybrid of the Federal Pell Grant and Federal Perkins Loan programs, employing the Federal Pell Grant electronic infrastructure for application, drawdown of funds, disbursement, reporting, and reconciliation.

Table 1 is the author's vision of all the functions a school would perform under direct lending, including current and new functions. It is the author's opinion that these functions are simple and straightforward in keeping with the Department's decision to regulate the outcome, not the means by which the outcome is achieved.

TABLE 1

Functional Analysis for Educational Institutions
Participating in the Federal Direct Student Loan Program

Function 1	Determine Borrower Eligibility and Loan Amounts
Function 2	Create and Transmit Loan Origination Records
Function 3	Obtain and Transfer Completed and Signed Promissory Notes
Function 4	Request Funds
Function 5	Disburse Funds
Function 6	Report Actual Disbursements
Function 7	Reconcile the Direct Loan Account
Function 8	Conduct Entrance and Exit Loan Interviews
Function 9	Complete Student Status Confirmation Reports
Function 10	Certify Eligibility for Deferment

Note: The order of these functions is arbitrary. Institutions have many options as to the sequence of these functions. Also, some of these functions are program-specific, others specific to certain categories of borrowers.

Practical Issues Confronting Educational Institutions in the Implementation of Direct Lending

Some of the major issues that concern educational institutions with respect to the implementation of direct lending are the Department's ability to manage the program, the quality of servicing under direct lending, and additional liabilities for schools. This section is limited to a discussion of the practical

issues schools face in the implementation of direct lending on the campus level.

This section addresses each of the functions identified in Table 1 and includes: an overview of the task; the steps involved in performing the task; the author's explanatory comments; and the author's identification of potential problem areas and/or the type of school(s) for which this function may be problematic. In the interest of brevity, problem areas are only highlighted, rather than resolved. However, in some instances there is a recommendation on how to address the problem. There is also a discussion of practical issues relating to the use of the Department's software or specifications and management of the Federal PLUS program.

Determine Borrower Eligibility and Loan Amounts

In essence, the function of determining loan amounts is that of determining student eligibility and, therefore, is the same function financial aid officers perform now under any of the Title IV programs.

Steps: (1) A student completes the Free Application for Federal Student Financial Aid (FAFSA) to apply for all forms of Title IV aid and submits it to the central processor. There is no additional application for a direct loan.

(2) The processor conducts central database matches and computes a student's eligibility according to the Federal need analysis.

(3) The school receives an electronic report from the processor. All EDE options for information exchange are available.

(4) Using the EDE packaging module or another packaging tool, the school determines the student's award package, including eligibility for Title IV aid, and sends the student an award notice.

(5) The school may include a Federal Stafford loan in the student's award package, or it may award the loan upon request of an eligible student.

Comments: Two relatively recent developments -- central database matches and the Electronic Data Exchange (EDE) -- streamline the process of determining borrower eligibility. The elimination of a separate loan application will substantially reduce a school's workload.

Concerns: Since the Direct Loan software will be a menu option under the Electronic Data Exchange, direct lending schools will need to become active EDE participants. Some schools have little or no experience with EDE. These schools will not be forced into a completely electronic environment as

there are different levels of participation and they can choose the most appropriate level.

Create and Transmit Loan Origination Records

The loan origination record contains the demographic, statistical, and financial information needed to create the borrower's permanent record in the Department of Education's database. The information for this record is similar to that which the school currently provides in its section on the FFELP application.

Steps: (1) Using the Department's software, or other software that meets the Department's specifications, the school creates a loan origination record. The school may create this record by importing data from the school's packaging database, and/or key entering the necessary data.

(2) The school transmits the electronic loan origination record to the servicer. The school may transmit this record any time prior to the first disbursement, or during the monthly reconciliation period following the first disbursement.

(3) The servicer receives the loan origination record, verifies it for completeness and accuracy, and stores it until the loan is booked or the record purged.

(4) If there is a problem with the loan origination record, the servicer contacts the school to resolve the problem.

(5) If the problem is not correctable by the school, the school contacts the borrower for resolution.

Comments: The loan origination record is the first set of information the servicer must receive in order to create the borrower's permanent record. The school may submit this record prior to transmitting the actual disbursement information and promissory note, or simultaneously. The school may not submit the loan origination record after transmitting the actual disbursement information and promissory note.

Concerns: The required statistical information for the loan origination record is an example of a requirement that existed in the FFELP that may be unnecessary in Direct Loans. Transmitting and storing statistical information -- such as, cost of attendance and estimated financial assistance -- increases institutional workload and may clutter the Department's database. In addition, this information may change during a student's loan period and therefore may not be accurate. This information is not stored centrally for Federal Perkins Loan recipients. The Department should review if the planned use of this statistical information justifies the work involved by all parties, especially

schools, to report it. If not, the Department should seek a technical amendment to delete the requirement for these data.

Obtain and Transfer Completed and Signed Promissory Notes

Obtaining and transferring the signed promissory note/disclosure to the Department of Education is the quintessential function institutions will perform under direct lending. A promissory note/disclosure is printed based on the loan origination record.

Steps: (1) The school prints a standardized promissory note on-site, or transmits the loan origination record to the servicer who prints and ships the promissory note back to the school.

(2) The school secures the borrower's references, signature, and date on the promissory note prior to disbursement. The school may deliver the promissory note to the student anytime after determining loan eligibility and prior to disbursing the loan.

(3) The borrower retains a copy of the executed promissory note.

(4) The school reviews the promissory note for completeness and accuracy prior to disbursing the loan.

(5) The school sends the promissory note/disclosure to the servicer in a batch with a transmittal form. The school may transmit the promissory note any time prior to the first disbursement, or during the monthly reconciliation period following the first disbursement.

(6) The servicer receives, reviews, and records receipt of the promissory note. The servicer creates and stores an imaged record of each form.

(7) The servicer informs the school within three business days of any unacceptable or incomplete promissory notes.

(8) The school resolves any errors on the promissory notes.

Comments: While the function of obtaining and transferring a legally enforceable note strikes many institutions as a daunting task, the Department's willingness to regulate outcome, not process, greatly facilitates an institution's ability to perform this function. For example, schools have options on how to print the note and how and when to secure the student's endorsement of the note.

Concerns: Schools who have not participated in the Federal Perkins Loan Program have little or no experience with this function, depending on whether

they have assisted FFELP lenders with this task. Schools without Federal Perkins Loan experience are required in the first year to participate through the alternate originator, thus requiring that they submit the promissory note prior to disbursing funds.

Request Funds

Originating schools are authorized to draw down funds for making Direct Loans, using the same process currently used for the Federal Pell Grant Program and the Federal campus-based programs, i.e., the Department of Education's Payment Management System (EDPMS). Funds are transferred using the Automated Clearing House/Electronic Funds Transfer method (ACH/EFT). For originating schools the drawdown of the funds is not dependent on the submission of individual borrower's loan records and/or promissory notes as explained in the following steps.

Steps: (1) The school anticipates its immediate cash need, defined as its need three days in advance of disbursement to the student.

(2) The school transmits an electronic payment request using the school-based software provided by the Department, or telephones its payment request to the EDPMS service bureau.

(3) The school's bank receives funds within forty-eight to seventy-two hours after the school transmits its drawdown request.

(4) Within three days, the school disburses the funds to eligible borrowers with properly executed promissory notes. If the school has an excess of funds which it does not anticipate needing, it returns the undisbursed funds.

Note: Schools using the alternate originator must submit the loan origination records and promissory note to the alternate originator before the alternate originator can draw down the funds.

Comments: The responsibility of working with the EDPMS is ordinarily the function of the business office or the office dealing with sponsored grants. Typically, the financial aid office anticipates the cash needs, and another office, most often the business office, requests the funds. Institutions developing a team approach to the administration of Direct Loans will be among the most successful.

Concerns: Schools with no prior experience in the Federal Pell Grant and/or campus-based programs will be unfamiliar with the EDPMS. However, the Department of Education anticipated this problem and only institutions that have participated in the Federal Perkins Loan Program may initially originate loans. Other institutions will use the Department's alternate originator for the drawdown of funds.

Disburse Funds

Under Direct Loans, the school controls when the student receives the funds -- within the limits of the regulations -- just as it now does under the Federal Pell Grant and campus-based programs. For originating schools, the disbursement of Direct Loans is not dependent on the submission of individual borrower records and/or promissory notes.

Steps: (1) The school establishes disbursement dates, taking into account the regulations concerning the number, amount, and timing of the disbursements.

(2) Prior to disbursing funds, the school reverifies the borrower's eligibility. This eligibility check is very similar to that performed for the Pell Grant and campus-based programs.

(3) The school credits the student's institutional account, or issues a check to the student for the net amount of the loan.

Note: Schools using the alternate originator must submit the loan origination records and promissory note to the alternate originator before the alternate originator can send the funds to the school for disbursement to borrowers.

Comments: There is no need for a separate written authorization, or acknowledgment, from the borrower in order to release the loan proceeds. The promissory note is sufficient notification from the school to the borrower. After the loan is "booked" with the servicer, the servicer will send the borrower an official notification of loan disbursement.

Concerns: There are two disbursement issues that will impact a school's workload, one that is within the Department's purview to correct and another that schools need to address. In developing the Direct Loan regulations, the Department adopted the FFELP multiple disbursement regulations, requiring schools to disburse all loans in more than one installment, including loans for one term. A single disbursement per term makes sense. However, multiple disbursements within a term unnecessarily increase a school's workload. As there are not multiple disbursements within a term under the Federal Perkins program, the Department should adhere to its stated goal of "simplicity" by adopting the Federal Perkins Loan disbursement provisions.

Under the FFEL program, some schools endorse the lender's check over to the student, thus eliminating the need to issue a new check. This happens at schools where the FFELP check is not needed for tuition and fees, most commonly low-cost institutions. For these schools, the task of issuing a check to the borrower is a new responsibility. However, a school may issue a check which includes all Title IV proceeds, such as the Federal Pell Grant and Federal Stafford, thus reducing the workload.

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Report Actual Disbursements

After disbursing funds, the school must report the required information on actual disbursements to the Department. The required information includes the loan disbursement amount and date.

Steps: (1) The school records the date and amount of each disbursement in the Department's software or in another system maintained by the school.

(2) The school transmits the disbursement record to the servicer by the end of the following monthly reconciliation period.

(3) The servicer receives, edits, and processes the disbursement record.

(4) If the disbursement record passes the edits, the borrower's record is updated. If there is a problem, the servicer contacts the school to resolve the problem.

(5) If the problem is not correctable by the school, the school contacts the borrower for resolution.

Comments: Actual disbursement data is reported electronically to the servicer, while the promissory notes are mailed to the servicer. Therefore, even if a school sends both sets of information simultaneously, the disbursement record will arrive first. This does not present problems, necessarily, as long as the time frame for "booking" a loan takes this difference into account.

Concerns: The Department is developing software and mainframe specifications for reporting the required information. Some thought should be given to potential problems stemming from confusion over gross and net loan amounts. Major problems could be averted if all institutional reporting is standardized to use gross loan amounts, with the software making automatic conversions to the net proceeds when necessary.

Reconcile the Direct Loan Account

Reconciliation is the second new activity schools perform under direct lending, although schools do perform reconciliation under other programs, most notably the Federal Pell Grant program.

The task of reconciliation comprises two separate, but not totally unrelated, activities: cash management reconciliation, indicated in steps 1 and 2; and individual loan record reconciliation, indicated in step 3.

Steps: (1) Once a month, the school uses the Department's software or its own system -- based on the Department's specifications -- to perform cash management reconciliation on all the cash transactions, including: drawdowns, disbursements, cancellations, return of excess cash, and cash on hand.

(2) If the reconciliation of these aggregate amounts is in agreement, there is no further reconciliation. If not in agreement, the school must resubmit information concerning individual borrower loan records.

(3) Once a month, the school uses the Department's software or its own system to perform individual borrower reconciliation. This reconciliation is similar to the Federal Pell Grant process of reconciling recipient data.

Comments: Because of the importance of accounting for fund disbursements and reconciling the account, schools may not draw down funds unless they reconcile the previous month's activities.

Concerns: Reconciliation may be a problem at schools that do not implement strong internal controls and/or good recordkeeping at the onset of the direct loan program, or who have a history of problems reconciling other programs, such as the Federal Pell Grant.

Conduct Entrance and Exit Loan Interviews

Conducting entrance and exit loan interviews is not a new activity, as schools currently perform these functions under the FFEL and Federal Perkins Loan programs.

Steps: (1) Prior to disbursing a loan to a first-time borrower at that institution, a school must conduct entrance counseling in person, or by mail in some exceptional cases.

(2) Before a borrower ceases to be enrolled less than half-time, the school must conduct exit counseling in person, or by mail in some exceptional cases.

Comments: Schools are required to conduct the same loan counseling as they do under the FFEL program. The difference is that some schools currently rely on lenders, guarantee agencies, and/or secondary markets for loan counseling materials. As a result, the Department will develop materials for use by schools.

Concerns: Mandating the type, timing, and frequency of loan counseling is another example of an approach used in the FFELP that may not be necessary for Direct Loans. Some schools, especially those with low default rates, may

have better alternatives for educating borrowers on their rights and responsibilities. For example, disseminating targeted written information over the course of the borrower's academic program may be more beneficial than a personal entrance loan interview.

Complete Student Status Confirmation Reports

One of the major functions schools currently perform is responding to requests concerning the enrollment status of borrowers so that borrowers will be placed in repayment promptly.

Steps: (1) Upon receipt of a request, a school verifies a student's current enrollment status and completes the Student Status Confirmation Report (SSCR) accordingly.

Comments: Schools currently perform this function under the FFELP and will continue to do so under Direct Loans.

Concerns: This function is currently problematic for schools who enroll a national pool of students, thereby increasing the likelihood that they will have to complete Student Status Confirmation Reports from multiple guarantee agencies. These schools will continue to receive SSCR reports for the FFEL and Direct Loan programs. The Department should consider the possibility of merging the various databases so that schools only respond to a request from one source. In addition, the Department should develop an electronic reporting option for this task.

Certify Eligibility for Deferment

Certifying eligibility for deferment is one of the tasks schools currently perform under the FFEL program. Ordinarily, this function is performed by the Registrar's Office. This task remains the same under Direct Loans.

Steps: (1) Upon receipt of a request, a school verifies a student's current enrollment status and completes the certification form accordingly.

Comments: This is a very straightforward task. It is helpful for the office certifying enrollment status to be knowledgeable of some, but not all, the provisions of the loan programs.

Concerns: While this function is simple in theory, in practice the composition of a school's population may add complexity. For example, schools with rolling admissions and/or significant number of students returning to school after withdrawal may find this task time-consuming. In essence, completion of the SSCR and certifying eligibility for deferment are the same task. Therefore, the Department should consider merging these two functions into one task of providing updated borrower enrollment information to the

servicer's database. The method for providing the updated data should be electronic.

Use the Department of Education's Software

This is not a function, but the means by which the other functions are performed. However, it is important to discuss this issue as the Department indicates that "state of the art technology" is one of its goals for Direct Loans. In addition, the direct lending addendum to the Program Participation in the July, 1993 regulation states that schools must use the Department's software or specifications to collect and transmit data.

Steps: (1) The school assesses whether it meets the minimum computer configuration specified by the Department. If not, the minimum hardware must be purchased.

(2) The school receives the Department's software and/or specifications.

(3) The school's information system personnel integrate the Direct Loan system with the institution's computer environment.

(4) The school performs a test run of the Direct Loan system.

(5) The Department confirms the quality of the test run.

(6) Institutional staff are trained in the use of the software.

(7) The school performs periodic quality review of its systems and implements corrective actions as necessary.

(8) The Department provides on-going support and training.

Comments: The hardware needed to participate in Direct Loans is quite modest and is already resident at most schools. Schools with high loan volume may need additional capacity.

Concerns: Schools with little or no experience in the use of computers will find this task challenging. However, all schools in the Federal campus-based programs submit their FISAP electronically. The FISAP software requires the same hardware configuration. Other school characteristics -- such as high loan volume, a decentralized environment, and lack of information management personnel -- impact the ease with which a school will function in the Direct Loan electronic environment.

Special Federal PLUS Program Issues

A school's role in the Federal PLUS program merits special consideration because many schools are concerned they will be asked to assume the lender's role with respect to the credit review.

The Department's Direct Lending Task Force should be congratulated for minimizing the role schools play in this program. The Direct Loan servicer will: request the credit information; evaluate the credit history; notify the parent of the approval or denial of the loan; assist parents with understanding their credit histories, correcting their credit histories when necessary, and refiling for a Federal PLUS loan. These functions would clearly be beyond the scope of most, if not all, schools.

Many schools are concerned about the possibility of having to issue a Federal PLUS loan check. The Task Force indicates that schools will post all Federal PLUS proceeds to a student's account. Schools only issue checks if the Federal PLUS amount exceeds current charges or if there is no student account.

Strategic Planning Approach for Institutions Preparing to Enter Direct Lending

The issue of strategic planning for schools preparing to enter direct lending should, and is, of importance to the Department of Education for several reasons. The tight time frame for year one of Direct Loans and the necessity of significantly increasing the number of participating schools in year two could adversely impact the successful implementation of direct lending.

This paper addresses some of the areas that need to be reviewed with respect to the issue of strategic planning:

(1) Does the Department of Education's implementation of direct lending facilitate strategic planning on the campus level?
(2) Who is in the best position to perform the strategic planning for schools?
(3) What models exist for this strategic planning?

Strategic planning is a military term meaning planning designed to destroy the military potential of the enemy. The opposite of strategic planning is tactical planning, designed to respond to the enemy's attacks. Simply put, in theory strategic planning allows one to preempt, tactical planning only to react.

One of the major problems with the Federal financial aid programs is that the Federal government -- including Congress and the Department of Education -- reacts to problems, rather than anticipating them and planning accordingly. As a result, the Department is placed in a position of responding to the onslaught of its enemy -- fraud and abuse -- by firing an endless stream of regulations in

all directions, in the hope the target will be hit. The problem is that innocent players are hit as well. As a result of this approach, schools are caught in a paradigm of crisis management and our customers, the students, are ill-served.

If we continue on this present course, neither direct lending nor any other initiatives will succeed. Therefore, it is important to reinvent government by identifying and correcting past management approaches that will negatively impact initiatives such as the implementation of Direct Loans.

If the Department adheres to its recently stated goals for Direct Loans of: "simplicity, integration, state of the art technology, customer service, and timeliness", schools will be placed in a position where strategic planning for direct lending can and will happen. The Department has a tremendous opportunity to create a loan program that will import the best features of the Federal Pell Grant and Federal Perkins Loan programs, and discard unnecessarily cumbersome FFELP regulations.

By keeping things simple and timely, the Department will create an environment which will be conducive to strategic planning for direct lending on the campus level.

Recent models circulated within the higher education community, such as one from Sallie Mae in the spring of 1993, lead schools to believe that strategic planning for direct lending is a formidable task. The author believes otherwise. The process for assessing one's degree of readiness for direct lending is very straightforward.

Because of the myriad of ways schools can, and do, manage financial aid programs, a school is in the best position to make the judgment of its own capabilities with respect to whether it is ready to enter direct lending, and if so, when. Schools not prepared to enter direct lending may opt not to apply for participation during the transition phase. Very few schools, if any at all, need the help of an outside entity to do this analysis of readiness for direct lending.

The simplest and best approach is for schools to look at the functions that need to be performed from the standpoint of the required human and financial resources. Table 2 is the author's proposed model for performing this strategic planning.

TABLE 2

Strategic Planning for Educational Institutions
Participating in the Federal Direct Student Loan Program

Function	Human Resources	Financial Resources
Integrate Direct Loan software		
Determine Borrower Eligibility		
Determine Loan Amounts		
Create Loan Origination Record		
Transmit Loan Origination Record		
Obtain Promissory Note		
Transfer Promissory Note		
Request Funds		
Disburse Funds		
Report Actual Disbursements		
Reconcile Direct Loan Account		
Conduct Entrance Interviews		
Conduct Exit Interviews		
Complete Borrower Status Reports		
Certify Eligibility for Deferment		
Special Federal PLUS Functions		

This model can be left simple or can be expanded in several ways. For example, the required human resource column could be subdivided into columns for the type of staff such as, professional, clerical, and technical. Similarly, the required financial resources column could be subdivided into columns for the type of expenses such as, computer expenses, supplies, postage, telephone, xeroxing etc.

The Department of Education and educational institutions are interdependent partners in direct lending. To ensure the success of Direct Loans, the Department may want to consider the advantages of taking a proactive role to encourage schools to assess their readiness, and prepare, for direct lending. One marketing approach may be to give schools short, succinct tips. For example, using the word "direct" as an acronym, a message to the schools preparing to enter direct lending could be:

D is for designate. Designate your direct lending team.

I is for integrate. Integrate direct lending into other processes.

R is for relegate. Relegate less important tasks accordingly.

E is for educate. Educate your direct lending staff early and thoroughly.

C is for communicate. Communicate up, down, and all around with everyone from senior staff to students.

T is for tailgate. Find a school that is implementing direct lending successfully and follow them closely!

The notion of networking as a key to the success of direct lending cannot be overemphasized. The Department can foster careful planning for direct lending from the onset through its selection of the initial schools and then by encouraging networking.

Flagship schools who have shown a strong commitment to direct lending can be selected to participate in the first year of the program and help the Department address implementation problems. In subsequent years, these schools can share their experiences by mentoring new schools, perhaps even through a program called "Tailgate"! Developing and marketing a cohort of experienced direct lending schools will be the Department's best motivational tool to involve new schools.

Possible Performance Indicators for Measuring an Educational Institution's Role and Impact in Direct Lending

This section is a cursory review of possible performance indicators for measuring a school's role and impact in direct lending. This topic needs to be placed in the broader context of the Department of Education's management of all the Federal student financial aid programs. The author only hopes to set out the dimensions of this issue for further research.

There is much evidence that the Department's current management strategy does not work. For example, it took six years to publish the FFELP regulations due to the complexity of the issues being micromanaged and regulated. During this time the national FFELP default rate soared.

On the other hand, there is evidence that the Quality Assurance program -- in which 100 schools currently participate -- produces the desirable results of identifying and correcting problems in the delivery of financial aid.

The Department should give strong consideration to adopting Total Quality Management (TQM) concepts and tools for its management of all the Federal student financial aid programs. Corporations have found this to be a critical first step to implementing quality improvement.

The ultimate measure of success in Direct Loans will be quality. But how to improve, rather than measure, quality, may be the more appropriate question to ask. The process of quality improvement begins with identifying the truly important quality issues and then learning how to find and remove factors which cause poor performance.

There is no doubt that schools will have a role in direct lending and that they can impact the outcome of the program. What is less clear is whether they can impact those areas for which they are now held accountable, such as the default rates of their students.

Before performance indicators can be developed, the Department needs to delineate the responsibilities of each of the partners in Direct Loans, something that unfortunately was not clear in FFELP.

Once this is done, it will be easier to apply the performance indicators. For example, if poor quality servicing results in some borrowers defaulting, and if loan servicing is defined as the responsibility of the Department's servicer, a school should not be measured by the default rate of these borrowers.

To identify appropriate quality issues it is essential to create greater focus on the customers, the consumer or users, of the product or service, and to seek

input from them. For example, one way to measure a school's performance in direct lending could be to have students complete a customer service survey, ranking a school's administration of the direct lending program. A survey may be an innovative way to educate borrowers about their rights and responsibilities and a subtle means of identifying attitudes that negatively impact repayment. The interactive nature of the survey also may engage students better than loan interviews.

Unquestionably the issue of performance indicators is important enough to warrant fuller discussion in another paper.

Conclusion

In conclusion, there is a wide array of views on the issue of an educational institution's workload under direct lending. The constant reassurances from the Department of Education that the Federal Direct Student Loan Program (Direct Loans) will not increase administrative workload or costs to institutions enables one to differentiate between the reality and perception of a school's role under direct lending. A topic for another paper is the impact of functions schools perform under direct lending on quality of student services.

In its first year, Direct Loans will be almost entirely based on the final regulations for the direct lending demonstration. These regulations clearly state what functions a school will perform. Based on these regulations, schools can begin determining the practical issues related to these tasks. Understanding the practical issues that await them, schools can proceed to the next level which is to plan strategically and prepare for the implementation of direct lending on the campus level.

The Department of Education can ensure the success of the Direct Loans by adhering to its stated goals of "simplicity, integration, state of the art technology, customer service, and timeliness", thereby also creating an atmosphere that facilitates strategic planning by schools.

Not only will schools have a role in direct lending, but they will have an impact on its success. New and more effective performance indicators of a school's impact are needed, especially when past measures have not served any of us in higher education well. The emergence of Total Quality Management (TQM) concepts and tools may present better options than the prior regulatory management approach.

New era, or old error, the decision is ours.

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